

ALL IN ONE BASKET: THE BANKRUPTCY RISK OF A NATIONAL AGENT-BASED MORTGAGE RECORDING SYSTEM

John Patrick Hunt,^{} Richard Stanton,[†] and Nancy Wallace[‡]*

Abstract

Mortgage Electronic Registration Systems, Inc. (“MERS, Inc.”) owns legal title to some 30 million mortgages in the United States. The company, which was a key part of the mortgage securitization apparatus in the late 1990s and 2000s, is now under intense pressure from public and private lawsuits and investigations and faces a very real threat of insolvency. Policymakers are looking ahead to potential replacements for MERS, Inc., as a recent Fed staff proposal for a substitute system indicates. This Article examines what might happen to the mortgages that MERS, Inc. at least nominally owns in the event that the company enters bankruptcy, a question that apparently has never been explored in a publicly available analysis.

Although the legal analysis underlying the design of MERS, Inc. does not appear to be publicly available, a key assumption seems to have been that if the company ever entered bankruptcy, the mortgages in its hands would not enter the company’s bankruptcy estate and would not be available to creditors. This Article challenges that assumption, pointing to the broad authority the Bankruptcy Code confers on the bankruptcy trustee with respect to interests in real property, such as mortgages. Most courts that have considered the issue have found that the bankruptcy trustee can bring into the estate any real property interest that the debtor could have conveyed to a good-faith purchaser. There is a significant risk that MERS, Inc. can convey MERS mortgages to a purchaser acting in good faith.

Although part of that risk arises from the company’s conduct in making and acquiescing in claims in court that the company can sell the mortgages, has constitutionally protected property interests in the mortgages, is a creditor of mortgage borrowers, and owns a beneficial interest in the mortgages, part of the risk is inherent in any mortgage recording system that operates nationally and holds mortgages as an agent. Policymakers should consider that risk as they consider whether MERS should be replaced and what form the replacement should take.

^{*} Assistant Professor of Law, University of California, Davis School of Law, jphunt@ucdavis.edu. A.B. Harvard College, J.D. Yale Law School. M.F.E. (Master’s in Financial Engineering) University of California, Berkeley Haas School of Business.

[†] Professor of Finance, Kingsford Capital Management Chair in Business, University of California Berkeley Haas School of Business, stanton@haas.berkeley.edu. B.A., M.A. Cambridge University, Ph.D. Stanford University.

[‡] Professor of Real Estate and Finance, Lisle and Roslyn Payne Chair in Real Estate and Capital Markets, University of California, Berkeley Haas School of Business, wallace@haas.berkeley.edu, B.A. University of Michigan, Maîtrise, Université de Paris, VIII, Ph.D. University of Michigan. The authors gratefully acknowledge helpful contributions from and discussions with Jack Ayer, Andrea Bjorklund, Anupam Chander, Joel Dobris, Katherine Florey, Jesse Fried, Robert W. Hillman, Dwight Jaffee, Meredith Kane, Tobias Keller, Christopher Klein, Evelyn Lewis, Lance Liebman, Eric Talley, Ken Taymor, and Rebecca Tushnet. We also appreciate excellent research assistance from Ronny Clausner and Sumair Khan. All opinions and errors are the authors' own.

Contents

I.	Introduction.....	1
II.	MERS, Mortgage Securitization, and Bankruptcy	6
A.	MERS and Mortgage Securitization	6
B.	Securitization and Bankruptcy	11
C.	The Threat of MERS, Inc. Bankruptcy	13
III.	Treatment of MERS Mortgages in Bankruptcy	16
A.	The MERS, Inc. Bankruptcy Trustee Probably Could Bring into the Bankruptcy Estate Any Mortgages That MERS, Inc. Could Convey to a Good-Faith Purchaser ...	16
B.	There Is a Significant Risk That MERS, Inc. Can Convey the Mortgages Recorded in its Name to a Bona Fide Purchaser, Either as Owner or as Agent	23
1.	MERS, Inc. as Mortgage Owner	24
2.	MERS, Inc. as Agent: The Power to Exercise “Any or All” Rights of the Lender	26
C.	MERS, Inc. as Hybrid Owner-Agent Under Section 544(a)(3)	32
1.	Policies Underlying Section 544(a)(3): Avoiding “Ostensible Ownership” Problems and Encouraging Use of the Recording System	33
2.	Creditors’ Ability to Reach Property Held for Principal	34
3.	Estoppel to Deny MERS, Inc.’s Authority to Convey Mortgages	35
4.	Countervailing Arguments:MERS Is Efficient, and “Too Big to Fail”	36
D.	Issues Relating to “Splitting the Mortgage and the Note” Do Not Interfere with the Operation of Section 544(a)(3)	38
IV.	Bankruptcy of MERS Versus Bankruptcy of the Trustee of an Express Trust	42
V.	Beyond MERS	47
VI.	Conclusion	49

I. INTRODUCTION

Some 30 million mortgages in the United States¹ are owned, nominally at least, by a company known as “MERS, Inc.”² that has no employees and no purpose other than owning legal title to mortgages as an agent for others.³ Since the beginning of the foreclosure crisis, this entity has come under increasing pressure from public and private lawsuits and investigations, and many informed observers have begun to wonder whether it will find itself compelled to file for bankruptcy. Nobody doubts that bankruptcy could be a calamity, although exactly what sort of calamity is a question that has not been fully explored. In particular, there is the matter of whether the mortgages to which MERS, Inc. has at least nominal title would pass into the company’s bankruptcy estate and become available to satisfy creditors’ claims. There is a presupposition that these mortgages cannot become part of the bankruptcy estate. This Article examines this presupposition, concluding that it is at least too hasty and may very well be wrong. In fact, there are straightforward arguments that the mortgages would pass to the bankruptcy trustee and become property of the estate. Even if these arguments do not in the end prevail, they are plausible enough to raise grave concerns among policymakers and investors.

The Mortgage Electronic Registration System, known as “MERS,” is a nationwide electronic mortgage registry that is supposed to track mortgage ownership and obviate recording

¹ Testimony of R.K. Arnold, President and CEO of MERSCORP, Inc. Before the Subcommittee on Housing and Community Opportunity, House Financial Services Comm., Nov. 18, 2010, at 11 [hereinafter Arnold Testimony] (“Since [MERS’] establishment in 1997, about 66 million loans have been registered and tracked on the MERS System. About half of those loans (about 31 million) are active mortgage loans.”).

² The legal name of the entity we call “MERS, Inc.” is “Mortgage Electronic Registration Systems, Inc.” MERS, Inc. is a subsidiary of MERSCORP, Inc. a privately held corporation. MERSCORP, Inc.’s owners are major participants in the mortgage industry.

³ See Deposition of William Hultman, Secretary & Treasurer of MERS, Inc., April 7, 2010, at 31 (MERS, Inc. is a “single purpose corporation that was incorporated for the sole purpose of holding title to the mortgage.”); *id.* at 69 (MERS, Inc. has no employees, and operates through thousands of officers employed by other parties).

of mortgage assignments with local authorities. MERS is operated by a company called MERSCORP, Inc.⁴ that is owned by the mortgage industry,⁵ and MERS, Inc. is a single-purpose subsidiary of MERSCORP, Inc. that holds legal title to the 30 million mortgages registered on MERS.⁶ The system has drawn intense attention during the foreclosure crisis, because mortgage borrowers frequently contest the issue of mortgage ownership. Some of the most widely read law review articles of the past few years criticize MERS.⁷ Most of this criticism comes from the standpoint of mortgage debtors and examines how MERS' deficiencies may create defenses for homeowners facing foreclosures.⁸ Critics writing in this vein also often take the part of local

⁴ The mortgage registry, MERS, apparently is operated by MERSCORP, Inc., the parent company of MERS, Inc. See Hultman Dep., *supra* note 3, at 29-31 (MERS, Inc. is a "single purpose corporation that was incorporated for the sole purpose of holding title to the mortgage.").

⁵ Arnold Testimony, *supra* note 1, at 1 n.1 (identifying principal owners of MERSCORP, Inc. as the Mortgage Bankers Association, Fannie Mae, Freddie Mac, Bank of America, Chase, HSBC, Citimortgage, GMAC, American Land Title Association, and Wells Fargo). MERSCORP, Inc. is the corporate parent of Mortgage Electronic Registration Systems, Inc. ("MERS, Inc."). MERSCORP, Inc. operates the MERS system. *Id.* at 8 n.8.

⁶ See Hultman Dep., *supra* note 3, at 31

⁷ See, e.g., Christopher L. Peterson, *Two Faces: Demystifying the Mortgage Electronic Registration System's Land Title Theory*, 53 WM. & MARY L. REV. 111, 120, 161 (2011) (downloaded 6,412 times on SSRN as of Jan. 2, 2012) [hereinafter *Two Faces*] (arguing that MERS maintains an "incoheren[t]" legal position that is "exacerbated by a corporate structure that is so unorthodox as to be considered arguably fraudulent" and comparing MERS, Inc. and the members of MERS to mythological figures such as Icarus who committed the "vital sin" of "hubris"); Christopher L. Peterson, *Foreclosure, Subprime Mortgage Lending, and the Mortgage Electronic Registration System*, 78 U. CIN. L. REV. 1359, 1407 (2010) (downloaded 4,290 times on SSRN as of Jan. 2, 2012) [hereinafter *Foreclosure and MERS*] (summing up its conclusions about MERS as follows: "the judiciary has an obligation to aggressively reexamine our financiers' cut corners, false assumptions, and jaundiced legal theory"); Nolan Robinson, *The Case Against Allowing Mortgage Electronic Registration Systems, Inc. (MERS) to Initiate Foreclosure Proceedings*, 32 CARDOZO L. REV. 1621, 1653-54 (2011) ("While the MERS system may be a 'commercially effective means of business,' it runs afoul of established foreclosure law, and courts should rule accordingly."); David P. Weber, *The Magic of the Mortgage Electronic Registration System: It Is and It Isn't*, 85 AM. BANKR. L.J. 230, 231 (2011) (arguing that use of MERS results in lack of transparency, insulation from damages of mortgage originators who may have engaged in fraud, and propagation of "a false dichotomy where MERS ... can claim to be the mortgagee when that status is to its benefit, while simultaneously disclaiming that role when it sees fit"); Tanya Marsh, *Foreclosures and the Failure of the American Land Title System*, 111 COLUM. L. REV. SIDEBAR 19, 24 (2011) ("The residential foreclosure crisis has brought MERS's flaws into clearer view. The inherent opaqueness of MERS has apparently hidden from public view some rather shoddy recordkeeping practices on the part of the lenders."); Dustin Zacks, *Standing in Our Own Sunshine: Reconsidering Standing, Transparency, and Accuracy in Foreclosures*, 29 QUINNIPAC L. REV. 551, 552 (2011) ("MERS's arguments to courts are so numerous and contradictory as to make pinning down one core theory of standing impossible").

⁸ See Peterson, *Foreclosure*, *supra* note 7, at 1407 ("[T]here is a compelling argument that loans where MERS is recorded as the original mortgagee should be avoidable by bankruptcy trustees in many states."); Peterson, *Two Faces*, *supra* note 7, at 141-43 (arguing that mortgages that name MERS as the original mortgagee are invalid because they do not name the true mortgagee, and that courts should respond by converting mortgages recorded on MERS into "equitable mortgages," which would give borrowers "significant leverage");

land recording authorities, pointing to fees lost due to the use of MERS.⁹ MERS also has its defenders, who emphasize the cost and time savings MERS offers its users.¹⁰ This Article does not take the perspective of mortgage debtors, foreclosing lenders or mortgage services, or land recording authorities. Instead, it addresses MERS from the standpoint of economic policymakers and mortgage investors.

Whether MERS ultimately prevails in its nationwide battle with mortgage borrowers or not, the effort to circumvent state real property law by centralizing nominal ownership of half of the mortgages in the United States in a legally untested shell entity poses a risk that should concern investors and policymakers charged with financial market stability. In fact, as this Article demonstrates, the efforts of MERS and its members to win the foreclosure wars have increased the risk that a MERS, Inc. bankruptcy poses to investors, financial markets, and the economy.

The reason that MERS mortgages are so vulnerable to bankruptcy is that the Bankruptcy Code, as interpreted by most courts, confers broad power on the bankruptcy trustee to bring real property interests such as mortgages into the bankruptcy estate, subjecting them to bankruptcy court jurisdiction and potentially making them available to satisfy creditors' claims.

⁹ See Peterson, *Two Faces*, *supra* note 7, at 115-17; Weber, *supra* note 7, at 2 ("loss of millions of dollars to the counties from recording"); Peterson, *Foreclosure and MERS*, *supra* note 7, at 1403 ("MERS is usurping the recording fees that once funded maintenance, innovation, and vigilance in public recordkeeping systems."); Nolan, *supra* note 7, at 1625 ("foreclosure actions brought in MERS' name, without joining the real party in interest, are unlawful"). See also *MERSCORP, Inc. v. Romaine*, 861 N.E.2d 81, 88-89 (N.Y. 2006) (Kaye, J., dissenting in part) (noting New York county clerks' concern about revenue loss).

¹⁰ See Gerald Korngold, *Legal and Policy Choices in the Aftermath of the Subprime and Mortgage Financing Crisis*, 60 S.C. L. REV. 727, 742-43 (2009) (arguing that MERS "facilitates an efficient secondary market in mortgages: by permitting transactions to be accomplished 'quickly at a low cost' and that courts and legislatures should address concerns about 'residential owners losing their homes' and 'hard-pressed borrowers in general' directly, rather than through rulings on MERS). Although Zacks criticizes MERS' self-contradictory theories of standing, he concludes that the system should be improved rather than terminated. Zacks, *supra* note 7, at 554 ("the best solution to the problems raised by widespread use of MERS is ... to bolster its information-storing capability by forcing it to store actual electronic documents that were previously recorded at the local recording level, such as mortgages and assignments," so that MERS can become "a modern alternative to outdated and inefficient recording practices").

Specifically, the bankruptcy trustee can bring into the estate under Section 544(a)(3) of the Code any real property interests the debtor could convey to a good-faith purchaser. Two factors combine to create a significant risk that a court would find that MERS, Inc. could convey MERS mortgages to a good-faith purchaser: the company's status as a hybrid owner/agent and the claims of extensive power over mortgages made on the company's behalf over the past few years in litigation.

If MERS mortgages were to enter the MERS, Inc. bankruptcy estate, some reasonable people might applaud the result. After all, the claimants would be public and private entities who have won judgments and levied fines against MERS, Inc. because they have prevailed on claims that the company engaged in wrongdoing.¹¹ The losers would be investors who chose to invest in MERS mortgages and who by and large have a more voluntary relationship with the company. Although many investors in mortgage-backed securities are pension funds set up for blameless rank-and-file employees, the claimants might as a group be more appealing than the investors. Indeed, that probably increases the likelihood that the claimants would prevail.

Although reasonable people could differ on whether MERS mortgages ought to enter the bankruptcy estate, there can be little doubt either that this result would represent a failure in MERS' design or that it would be a most significant development. It would be important because investors in MERS mortgages include the nation's largest banks, those highly leveraged institutions treated as indispensable to financial stability.¹² Placing MERS mortgages under the administration of the bankruptcy court would create market uncertainty. Forcing investors to share the value of MERS mortgages does have implications for financial stability. The fact is

¹¹ See discussion *infra* Part II. C.

¹² See, e.g., Financial Stability Board, Policy Measures to Address Systemically Important Financial Institutions, Nov. 4, 2011, at 4 (listing "financial institutions whose distress or disorderly failure ... would cause significant disruption to the wider financial system and economic activity.").

that trillions of dollars have been invested on the implicit assumption that MERS mortgages would not enter MERS, Inc.'s bankruptcy estate. It is worth understanding the merits of this assumption, whether we like the results or not.

MERS as it currently exists is uniquely vulnerable to the problems identified here due to its history, but the issues raised in this Article attend any entity that conveys title to mortgages as an agent and can enter bankruptcy. Policymakers should take them into account in the ongoing discussion of the land title recording system in the United States. For example, the Federal Reserve's staff recently suggested creating a national lien recording system.¹³ The proposal as it stands does not prescribe any specific legal form for the registry, but if the proposal moves forward it should take into account the risks of holding mortgages in an agent that can enter bankruptcy.

Part II of this Article explains MERS' pivotal role in the mortgage securitization markets, explores the effects of a finding that MERS owns the mortgages registered in its name, and demonstrates the risk that MERS, Inc. will become insolvent and seek bankruptcy protection. Part III explains the legal arguments under which MERS mortgages could enter the MERS, Inc. bankruptcy estate. Part IV contrasts the case of a MERS, Inc. bankruptcy with the bankruptcy of the trustee of an express trust. Part V explores alternatives to MERS, and Part VI concludes.

¹³ See BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE U.S. HOUSING MARKET: CURRENT CONDITIONS AND POLICY CONSIDERATIONS (Jan. 4, 2012).

II. MERS, MORTGAGE SECURITIZATION, AND BANKRUPTCY

A. MERS and Mortgage Securitization

Over 30 million mortgages,¹⁴ around half of the loans active in the United States,¹⁵ are currently recorded in MERS, Inc.'s name. The system has in its 14 years of existence¹⁶ become a central part of the nation's housing infrastructure.

MERS owes its dizzying ascent to mortgage securitization, a practice that places a premium on streamlining mortgage transfers.¹⁷ The typical mortgage securitization involves the transfer of several thousand mortgages, usually from different parts of the country,¹⁸ to a "special purpose vehicle" or "SPV," usually a trust, that issues certificates to investors. In the typical transaction from the 2000s, each mortgage was transferred several times in the course of the deal: from the originator to an entity called a "sponsor," thence to another entity called a "depositor," and finally to the trust.¹⁹ A single mortgage securitization transaction thus would

¹⁴ Arnold Testimony, *supra* note 1, at 1.

¹⁵ Arnold Testimony, *supra* note 1, at 10.

¹⁶ Arnold Testimony, *supra* note 1, at 11 (MERS established in 1997).

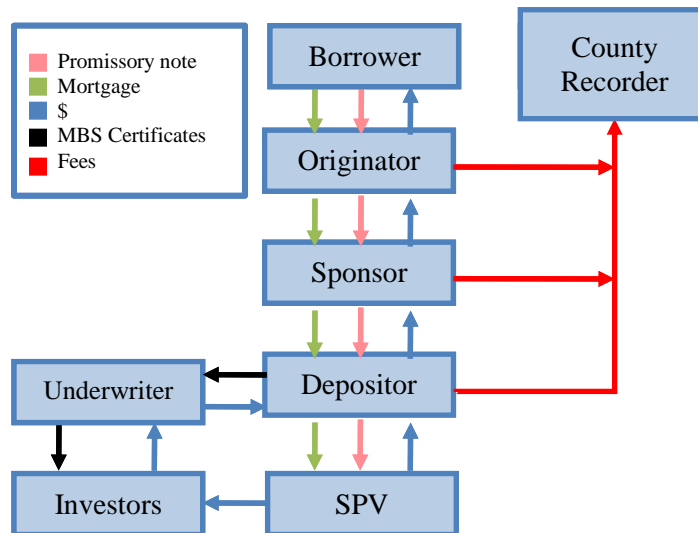
¹⁷ See INTERAGENCY TECHNOLOGY TASK FORCE, WHOLE LOAN BOOK ENTRY CONCEPT FOR THE MORTGAGE FINANCE INDUSTRY II-1 (1993) ("Today, the process for transferring and tracking mortgage rights is paper-intensive, time-consuming, and costly. A major portion of these costs stem from the need to prepare, record, and manage physical assignment documents that are required to evidence interests in mortgages."); Phyllis K. Slessinger & Daniel McLaughlin, *Mortgage Electronic Registration System*, 31 IDAHO L. REV. 805, 808 (1995) ("The establishment of MERS will greatly simplify a terribly cumbersome, paper-intensive, error-prone, and therefore costly process for transferring and tracking mortgage rights."). This law review article is important for understanding MERS' genesis because the authors were the Senior Director, Secondary Market & Investor Relations, and the Director of Technology Initiatives at the Mortgage Bankers Association while MERS was planned and they appear to have been involved in its creation. *Id.* at 805.

¹⁸ See Prospectus Supplement dated Sept. 7, 2006 for Mortgage Pass-Through Certificates issued by GSAMP Trust 2006-HE3, at S-40 (describing mortgage pool for one transaction as containing 10,736 mortgage loans with aggregate principal balance of \$1.6 billion, with no more than 0.23% of the loans secured by properties in any one area).

¹⁹ The apparently superfluous sponsor-depositor step appears to have its origins in accounting rules adopted in the early 2000s. See Financial Accounting Standards Board [hereinafter FASB], Statement of Financial Accounting Standards No. 140 [hereinafter FAS 140] § 9 (2000); FASB Technical Bulletin No. 01-1 (2008); Deloitte & Touche, *Learning the Norwalk Two Step*, HEADS UP, April 25, 2001, at 4; Marty Rosenblatt, Jim Johnson & Jim Mountain, *Securitization Accounting: The Ins and Outs (And Some Do's and Don'ts) of FASB 140, FIN 46R, IAS 39 and More* (2005). "FAS 140" is technically an outdated term. The Financial Accounting Standards Board has adopted a new codification of accounting standards (the "Accounting Standards Codification" or "A.S.C.") that apparently became effective on September 15, 2009. See FASB, A.S.C. 105-10-05-1. A.S.C. 861-10-40 covers the aspects of FAS 140 relevant to our discussion.

require that tens of thousands of individual mortgage transfers be completed in a short time, typically sixty days. The green arrows in Figure 1 indicate the path the mortgage would have to travel in a typical securitization.

Figure 1: Mortgage and Promissory Note Transfer with Traditional Recording



State recording statutes generally provide that if a mortgage transfer is not recorded, the transferee is vulnerable to competing claims.²⁰ Like other unrecorded interests in real property, unrecorded interests in mortgages generally are vulnerable to subsequent claimants.²¹ States generally maintain land records at the county level, so recording a mortgage assignment historically entailed dealing with an official in the county where the property was located (and paying a fee). County recorders and clerks reportedly are often short on resources and have

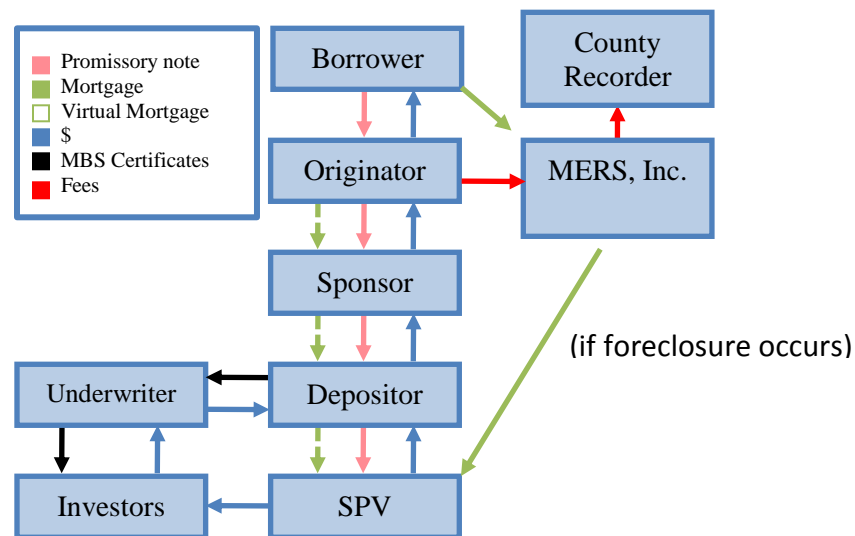
²⁰ The authors recently surveyed the recording statutes of the “Top Ten” mortgage securitization states: the ten states with the largest numbers of mortgages securitized in private transactions and found that statutes in nine of the top ten states require that mortgage assignments be recorded to protect the mortgagee’s interest. The states covered in the survey are California, Florida, Texas, Illinois, New York, Arizona, Georgia, Virginia, Michigan, and Maryland. Of these, Georgia is the only state that does not require recording. The survey is on file with the authors.

²¹ For example, if A were to assign the mortgage to B, who did not record its interest, and then transfer the same mortgage to C, who did record its interest, C could prevail over A. *See* 14 RICHARD R. POWELL ET AL., POWELL ON REAL PROPERTY § 82.02[1][b] (2011).

backlogs of work, so that recording, say, 30,000 mortgage assignments in 1,000 different counties in sixty days would have been a daunting task.²²

MERS was intended to ease the burden on securitization arrangers by substituting a national electronic database for county recording of mortgage assignments. The original lender would record the original mortgage in county records in MERS' name, and subsequent assignments would be tracked on the electronic system rather than recorded in states' official records. Figure 2 illustrates this process.²³ The green arrow from "Borrower" to "MERS, Inc." represents the fact that MERS, Inc. is recorded as the legal owner of the mortgage, as nominee on behalf of the originator.²⁴ Subsequent transfers are not recorded, other than in MERS, Inc.'s database. The broken green arrows represent this. In the event of foreclosure, MERS, Inc. may record an assignment of the mortgage to the SPV.

Figure 2: Mortgage and Promissory Note Transfer with MERS Recording



²² See Arnold Testimony, *supra* note 1, at 18 ("[A]t certain time periods, the flow of assignments were [sic] overwhelming the county recorder system, resulting in long backlogs, and in some cases, taking the county recorded over a year to record an assignment.").

²³ See Arnold Testimony, *supra* note 1, at 16-20 (describing use of MERS to track mortgage assignments).

²⁴ Figure 2 and the text describe a situation where MERS, Inc. is the original mortgagee, known as a "MOM" mortgage. In other situations, the original lender may assign the loan to MERS, Inc.

Although MERS undoubtedly seemed like a simple and attractive solution for the industry – hence its widespread adoption – there is little publicly available evidence that it was carefully designed to take account of widely varying state laws relating to mortgage recording, foreclosure procedure, and the legal form of mortgages.²⁵ The mortgage crisis has brought MERS’ potential deficiencies to the fore, as the foreclosure defense and consumer bankruptcy bars have raised myriad questions about MERS’ legal and technical sufficiency under the laws of nearly every state.²⁶

It is difficult to generalize about the overall trend in the hundreds, if not thousands, of reported foreclosure defense cases involving MERS,²⁷ and MERS certainly has suffered some important defeats,²⁸ but if anything the trend in foreclosure litigation appears to be in MERS’

²⁵ For example, the 1993 white paper that presented the MERS concept devoted two of its 36 pages to discussing the legal and regulatory framework for the system. The paper states that MERS “is essentially designed to be capable for implementation within the current legal framework” but does not treat differences among the states’ laws or address potential insolvency of the legal entity operating the system. *See, e.g.*, INTERAGENCY TECH. TASK FORCE, *supra* note 17, at III-11 to III-13 (asserting that the MERS concept “is essentially designed to be capable for implementation within the current legal framework”). R.K. Arnold testified to Congress that “[a] review of the use of MERS in all fifty states was done by Covington and Burling in 1996 and 1997 as part of the due diligence associated with the creation of MERS. It is available upon request.” Arnold Testimony, *supra* note 1, at 20 n.16. One of the authors requested this document using the automated “Contact Us” feature of the mersinc.org Website on January 3, 2012, and via phone and e-mail on several subsequent occasions. The inquiries were referred to a MERSCORP staff member who has not responded to them.

²⁶ Although the most salient problems with MERS are that it degrades land records and promotes fraud because it is apparently quite easy to become an officer of MERS, Inc. and make entries on the registration system, defenses have focused on technical issues such as whether MERS splits mortgage and note or whether its status as “nominee” confers sufficient authority on the company to assign or foreclose on mortgages. *See discussion infra* Part III. B.

²⁷ A search on the terms “MERS and foreclosure” in the ALLCASES database on Westlaw on Jan. 4, 2012 returned 2,202 documents.

²⁸ The Supreme Judicial Court of Maine has made rulings adverse to MERS’ basic legal theories. *See HSBC Bank USA v. Gabay*, 28 A.3d 1158 (Me. 2011) (rejecting MERS’ claim to be able to assign note along with mortgage); *MERS, Inc. v. Saunders*, 2 A.3d 289 (Me. 2010) (MERS lacks standing to foreclose because it lacks an interest in the promissory note). Other state supreme courts have held that when a mortgage is recorded on MERS, a foreclosure based on *another* mortgage on the same property can go forward without MERS, Inc.’s participation. *See MERS, Inc. v. Southwest Homes of Arkansas* 301 S.W.3d 1 (Ark. 2009) (because MERS is “at most at an agent” of the lender, it is not a necessary party to a foreclosure action on property subject to a mortgage entered on MERS); *Landmark Nat’l Bank v. Kesler*, 216 P.3d 158 (Kan. 2009) (MERS is “more akin to that of a straw man than to a party possessing all the rights given a buyer,” so it was not error to permit foreclosure on a property subject to a mortgage entered on MERS). These holdings, however, do not directly bear on disputes between borrowers and lenders over MERS mortgages.

favor, both in state supreme courts²⁹ and in federal cases accusing MERS, Inc. of wrongful foreclosure,³⁰ even as law enforcement and government officials demonstrate increasing skepticism toward MERS.³¹ Although this trend could well change, as the law-enforcement actions against MERS, Inc. do attack the company's basic business practices,³² for the moment it seems that judicial wariness about letting borrowers get away with default more often than not overcomes qualms about MERS' strict compliance with state laws.

But MERS' very success in litigation should make investors nervous, because the imperatives of winning foreclosure cases against borrowers have forced MERS and its members to cast MERS as much more than a mere registration system. Instead, foreclosures proceed because courts accept descriptions of MERS as an agent of the lender possessing the right as agent to do anything with respect to the mortgage that the lender itself could do, particularly the right to assign the mortgage. MERS has even successfully claimed to own mortgages and to

²⁹ For example, considering only the highest decisions of state courts rendered in 2011, MERS won in *Residential Funding Co., L.L.C. v. Saurman*, 805 N.W.2d 183 (Mich. 2011) (MERS' interest in security lien authorized MERS to foreclose by advertisement); *Savage v. U.S. Bank, N.A.*, 19 A.3d 302 (Del. 2011) (rejecting borrowers' contention that they were entitled to notice of mortgage assignment from MERS to foreclosing bank); *RMS Res. Props., LLC v. Miller*, 32 A.3d 307 (Conn. 2011) (rejecting borrowers' contention that MERS could not validly be named mortgagee because it was not the lender); *Thomas v. BAC Home Loans Servicing, LLP*, No. 56587, 2011 WL 6743044, at *3 (Nev. Dec. 20, 2011) ("MERS as the nominee beneficiary holds the deed of trust for BAC's benefit"). Cases in which MERS' positions were rejected tended to focus on case-specific evidentiary matters. *See Bank of New York v. Bailey*, 951 N.E.2d 331 (Mass. 2011) (summary judgment for bank in process for possession after foreclosure by sale denied because bank did not submit proper affidavit; MERS' role not addressed although MERS purported to assign mortgage and note to foreclosing bank); *HSBC Mortgage Servs., Inc. v. Murphy*, 19 A.3d 815 (Me. 2011) (judgment of foreclosure denied because of "serious irregularities" in lender's inconsistent affidavits); *U.S. Bank, N.A. v. Kimball*, 27 A.3d 1087 (Vt. 2011) (bank abandoned claim that MERS mortgage assignment sufficed to establish interest in promissory note); *Bevilacqua v. Rodriguez*, 955 N.E.2d 762, 771-72 (Mass. 2011) (purchaser at foreclosure sale lacked standing to try title where purchaser conceded that MERS did not assign deed to foreclosing bank before foreclosure) *Heredia-Bonnet v. First American Loanstar Trustee Servs., LLC*, 2011 WL 5006303 (Nev. Oct. 18, 2011) (unpub'd) (foreclosure denied because MERS failed to produce deed of trust at mediation).

³⁰ *See In re Mortgage Elec. Reg. Sys. (MERS) Litig.*, No. 09-2119-JAT, 2011 WL 4550189, at *3 (D. Ariz. Oct. 3, 2011) (dismissing 72 cases against MERS based on theories that MERS is not a beneficiary of deeds of trust, that MERS Deeds of Trust are not valid and enforceable because they never named a valid beneficiary and were split from the note at creation, and that MERS cannot assign deeds of trust).

³¹ *See discussion infra* Part II. C.

³² *See, e.g.,* Complaint, *People of the State of New York v. JPMorgan Chase Bank, N.A. et al.* (N.Y. Sup. Ct. Kings County Feb. 3, 2012), Relief, ¶ B [hereinafter New York Complaint] (seeking to enjoin MERS, Inc. from operating through non-employee certifying officers).

possess a constitutionally protected property interest in the mortgages. As explained below,³³ these claims increase the risk that if MERS enters bankruptcy, the mortgages to which it holds legal title will enter the MERS bankruptcy estate.

B. Securitization and Bankruptcy

Mortgage securitization is based on the premise that buyers of mortgage-backed securities are entitled to the flow of funds from the underlying notes and will not have to share those funds with anyone else.³⁴ As a corollary, investors are assumed to be entitled to the value of the security interests securing the notes. In particular, investors are not supposed to have to share the value of the mortgages with creditors of the original lender or anyone else in the securitization chain. The bankruptcy of an entity in the securitization chain could lead to this kind of forced sharing, because the bankruptcy process gathers the assets of the bankrupt debtor into a bankruptcy estate for distribution to creditors according to bankruptcy rules.

Securitization transactions thus are designed to minimize the possibility that the securitized assets will be subject to this process. That is, they are designed so that the assets will not enter any party's bankruptcy estate. The baroque originator-sponsor-depositor-SPV transfer sequence described above was adopted to achieve bankruptcy remoteness, and securitization transactions are accompanied by lawyers' letters opining that the structures are effective in doing so.³⁵

³³ See discussion *infra* Part III. B.

³⁴ Steven Schwarcz, *Securitization Post-Enron*, 25 CARDOZO L. REV. 1539, 1573-74 (2004); Thomas E. Plank, *Sense & Sensibility in Securitization*, 30 CARDOZO L. REV. 617, 619 (2008) (mortgage securitization lowers financing costs because it avoids the costs that the Bankruptcy Code imposes—unwisely, in my view—on secured creditors"); Kenneth C. Kettering, *Securitization and Its Discontents: The Dynamics of Financial Product Development*, 29 CARDOZO L. REV. 1553, 1561 (2008) ("The prototypical securitization structure has no purpose, and no significant effect, other than to circumvent the ... 'Bankruptcy Tax' that the Bankruptcy Code can be thought of as imposing on secured lenders ...").

³⁵ The bankruptcy opinion letters given in connection with mortgage securitization transactions apparently are not public. These letters may be limited to concluding that the transferred assets would not become part of the

Securitization can be seen as a way of transacting around bankruptcy, and much academic commentary attempting to explain why securitization happens focuses on the importance of transacting around bankruptcy.³⁶ Likewise, the debate over whether securitization is good or bad is to a very large extent a debate over whether contracting around bankruptcy is good or bad.³⁷

Whether contracting around bankruptcy is desirable or not, the fact is that vast sums have been invested on the assumption that mortgage securitization does in fact insulate investors from the bankruptcy of entities in the securitization chain, despite the misgivings expressed by many scholars about the likely effectiveness of securitization structures in accomplishing this goal.³⁸

transferor's bankruptcy estate and may not address the possibility of a MERS bankruptcy. See, e.g., James R. Mountain et al., *New Developments in Securitization 2010*, 930 PLI/COMM 1055, 1088-89 (2010) (giving examples of legal opinions found persuasive by accountants; examples assert only bankruptcy remoteness from "Seller"). Even if the legal opinions are so limited, the basic assumption of bankruptcy remoteness would be thwarted as much by the mortgages' entry into the MERS, Inc. bankruptcy estate as by their entry into the transferor's bankruptcy estate.

³⁶ See sources cited *supra* note 34. This argument has also been advanced in the economic literature. See Kenneth Ayotte & Stav Gaon, *Asset-Backed Securities: Cost and Benefits of "Bankruptcy Remoteness,"* 24 REV. FIN. STUDS. 1299 (2011); Gary Gorton & Nicholas Souleles, *Special Purpose Vehicles and Securitization*, in THE RISKS OF FINANCIAL INSTITUTIONS 549 (Mark Carey & René M. Stulz eds. 2006); Gary B. Gorton & Andrew Metrick, *Securitization*, Working paper, Yale University (2011). A popular alternative explanation is that pooling financial assets increases the cost of becoming informed about the pool's aggregate payoffs and therefore induces intermediaries to remain uninformed, so that end purchasers are not deterred from buying because of the intermediary's superior information. See Edward Iacobucci & Ralph Winter, *Asset Securitization and Asymmetric Information*, 34 J. LEGAL STUDS. 161 (2005); Edward L. Glaeser & Hedi H. Kallal, *Thin Markets, Asymmetric Information, and Mortgage-Backed Securities*, 6 J. FIN. INTERMEDIATION 64 (1997); Claire Hill, *Securitization: A Low Cost Sweetener for Lemons*, 74 WASH. U.L.Q. 1061 (1996). Other explanations for securitization include signaling benefits, see Stuart Greenbaum & Anjan Thakor, *Bank Funding Modes: Securitization versus Deposits*, 11 J. BANKING & FIN. 379 (1987), regulatory capital arbitrage, see George Pennacchi, *Loan Sales and the Cost of Bank Capital*, 43 J. FIN. 375 (1988), and tax savings, see Hayne Leland, *Financial Synergies and the Optimal Scope of the Firm: Implications for Mergers, Spinoffs, and Structured Finance*, 92 J. FIN. 765 (2007).

³⁷ So understood, the question of securitization's desirability is a "transposition into a minor key of the larger question" of the desirability of secured credit. See Kettering, *supra* note 34, at 1717. As Kettering points out, "[b]y relieving financiers of the burden of the Bankruptcy Tax, securitization does no more than enhance the rights of secured creditors." *Id.* The debate over secured credit, in turn, has spawned a large literature. See *id.* at nn. 541-42 (collecting articles addressing the issue); see also Lucian Arye Bebchuk & Jesse M. Fried, *The Uneasy Case for the Priority of Secured Claims in Bankruptcy*, 105 YALE L.J. 857, 859 (1996) (arguing that "the efficiency case for full priority [for secured claims in bankruptcy] is at best problematic" because preferential treatment of secured creditors induces inefficient behavior by debtors and lenders and suggesting possible ways to reduce the preference afforded secured debt).

³⁸ See David Gray Carlson, *The Rotten Foundations of Securitization*, 39 WM. & MARY L. REV. 1055 (1998); Lois R. Lupica, *Asset Securitization: The Unsecured Creditor's Perspective*, 76 TEX. L. REV. 595, 636-50 (1998); Kenneth N. Klee & Brendt C. Butler, *Asset-Backed Securitization, Special Purpose Vehicles and Other*

The nation's banking system is heavily invested in these instruments,³⁹ so the concentration of 30 million mortgages in MERS, Inc. poses a systemic risk.

C. The Threat of MERS, Inc. Bankruptcy

MERS, Inc. apparently is a shell company without substantial assets other than the mortgages it holds.⁴⁰ The assumption behind structuring MERS, Inc. in this way presumably was that the company would not face substantial litigation risk. This assumption was always questionable in light of the scope, novelty, and nature of the plan for MERS, Inc.'s intended operation – owning legal title to, assigning, and foreclosing on millions of mortgages.⁴¹ This is contentious business, as the many lawsuits now pending against MERS, Inc. and its parent MERSCORP, Inc. demonstrate.

MERS, Inc. has been sued by the Attorneys General of Delaware,⁴² Massachusetts,⁴³ and New York.⁴⁴ The Delaware complaint alleges that the MERS companies have violated the

Securitization Issues, 35 U.C.C. L.J. 23 (2002); Kettering, *supra* note 34, at 1585 (“Fraudulent transfer law can be applied, consistent with established usages, to avoid the asset transfer from Originator to SPE that is the core of the prototypical securitization transaction, in order to vindicate the bankruptcy policy that the securitization structure is designed to circumvent.”). Kettering also argues that “a bankruptcy court so inclined could readily defeat the prototypical securitization structure by ordering the substantive consolidation of the Originator and the SPE.” *Id.* at 1562

³⁹ See, e.g., BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, FLOW OF FUNDS ACCOUNTS OF THE UNITED STATES, Dec. 8, 2011, at L.110 (reporting that U.S.-chartered commercial banks hold over \$1.1 trillion in residential mortgage-backed securities, over 10% of total assets).

⁴⁰ See Deposition of William Hultman, *supra* note 3, at 31, 69. MERS, Inc.'s financial statements apparently are not publicly available.

⁴¹ MERS' architects drew an analogy between MERS and the book-entry system used for stocks. See INTERAGENCY TECH. TASK FORCE, *supra* note 17, at I-4 (“Existing business entities such as the Depository Trust Corporation (DTC) and the Participants Trust Corporation (PTC) provide successful models for establishing a structure for the WLBE Clearinghouse [MERS].”). One weakness of this analogy is mortgages often have to be enforced through foreclosure, which very frequently entails litigation. This large source of litigation risk does not exist for stocks.

⁴² Verified Complaint, *State of Delaware v. MERSCORP, Inc.*, (Ct. Ch. Del. Oct. 27, 2011) [hereinafter Delaware Complaint].

⁴³ Complaint, *Commonwealth of Massachusetts v. Bank of America et al.* (Suffolk Cty. Super. Ct. Dec. 1, 2011) [hereinafter Massachusetts Complaint].

⁴⁴ New York Complaint, *supra* note 32.

state's Deceptive Practices Act⁴⁵ and seeks substantial monetary relief, including civil penalties of \$10,000 per violation,⁴⁶ restitution to affected borrowers,⁴⁷ and the State's costs of investigation and attorney's fees.⁴⁸ The Massachusetts suit alleges violations of the Massachusetts Consumer Protection Act⁴⁹ and seeks similar penalties.⁵⁰ The New York suit seeks damages for fraud and deceptive business practices,⁵¹ as well as disgorgement of profits⁵² and civil penalties of \$5,000 per violation for deceptive practices.⁵³

At this writing, MERS, Inc. is a defendant in multidistrict litigation pled by 72 individual plaintiffs⁵⁴ as a class action on behalf of all residents of Arizona, California, Nevada, and South Carolina⁵⁵ damaged by certain conduct of MERS, Inc. and other major mortgage industry participants. The gravamen of the lawsuit is that recording in the name of MERS, Inc. as nominee splits mortgage and note, causing the note to become unsecured,⁵⁶ so that efforts to foreclose on MERS mortgages are wrongful. Although the district court dismissed most of these lawsuits,⁵⁷ its decision has been appealed to the Ninth Circuit,⁵⁸ and the scope of the action illustrates the potential magnitude of MERS, Inc.'s exposure.

⁴⁵ Delaware Complaint, ¶ 4.

⁴⁶ *Id.* ¶ 189.

⁴⁷ *Id.* ¶ 190.

⁴⁸ *Id.* ¶ 191.

⁴⁹ Massachusetts Complaint, ¶ 1.

⁵⁰ *Id.*, Prayer for Relief, ¶ 1.

⁵¹ New York Complaint, Relief, ¶ F.

⁵² *Id.* ¶ E.

⁵³ *Id.* ¶ G.

⁵⁴ See United States Judicial Panel on Multidistrict Litigation, "Pending MDLs," http://www.jpml.uscourts.gov/Pending_MDLS/pending_mdls.html, accessed Aug. 9, 2011.

⁵⁵ See Plaintiffs' Consolidated Amended Master Complaint Regarding Claims Related to the Formation and Operation of the MERS System, June 4, 2011, Case No. 02:09-md-02119-JAT (D. Ariz.) (MDL-2119) [hereinafter MDL Complaint], at ¶¶ 226-27.

⁵⁶ MDL Complaint, ¶¶ 7, 10.

⁵⁷ See *In re MERS Litig.*, No. 09-2119-JAT, 2011 WL 4550189 (D. Ariz. Oct. 3, 2011).

⁵⁸ See Joint Notice of Appeal, *In re MERS Litig.*, No. 2:09-md-02119 JAT (D. Ariz.), filed Oct. 26, 2011.

MERS, Inc. also faces potential claims from county recorders. Local recorders in Massachusetts⁵⁹ and North Carolina⁶⁰ have suggested that MERS, Inc. owes large sums in evaded filing fees. State attorneys general, are currently investigating the company⁶¹ and could commence formal action against it. Massachusetts' Attorney General recently declared that her state "will not sign on" to any settlement that includes a comprehensive liability release for "securitization and MERS conduct" and that "responsible parties must be held accountable in order to fully protect homeowners and return to a healthy economy."⁶² Senator Maria Cantwell recently advised the Attorney General bluntly, "The Mortgage Electronic Registration System should be shut down and dissolved."⁶³

Certainly, MERS, Inc. may escape unscathed from the lawsuits and investigations in which it is currently entangled.⁶⁴ But the scenario in which MERS, Inc.'s adversaries prevail and become large creditors so that MERS, Inc. enters into bankruptcy can hardly be described as a "remote" possibility. This is true even though MERS, Inc. is supposed to be structured as a

⁵⁹ See Press Release, Commonwealth of Massachusetts Southern Essex District Registry of Deeds, Feb. 22, 2011 ("Essex South Register of Deeds John O'Brien announced today that he will be seeking over 22 million dollars from the Mortgage Electronic Registration System.").

⁶⁰ See Press Release, Guilford County, North Carolina Register of Deeds, March 2, 2011 ("Guilford County Register of Deeds Jeff Thigpen announced today that he will be conferring with [law enforcement officials] as to whether the Mortgage Electronic Registration Service [sic] (MERS) owes Guilford County fees estimated at \$1.3 million in lost revenue from mortgage assignments.").

⁶¹ Letter from Martha Coakley, Attorney General, Commonwealth of Massachusetts to William P. O'Donnell, Register of Deeds, Norfolk Registry District of the Land Court, July 25, 2011 ("[W]e are currently investigating creditor misconduct in connection with unlawful foreclosures ... We have focused particularly on creditors' reliance on MERS and whether MERS conforms to the requirements of Massachusetts law, in the context of foreclosures and otherwise. In the next week, we plan to send civil investigative demands to Registers in order to gather critical information to our investigation, and appreciate your continuing cooperation in this process.").

⁶² *Id.*

⁶³ Letter from Senator Maria Cantwell to Attorney General Eric Holder, Dec. 15, 2011.

⁶⁴ The basic point of the private lawsuit is that MERS, Inc. lacked authority to assign and foreclose mortgages. That may appear to be in tension with the argument presented here, that MERS, Inc. appears to have authority to sell mortgages. Thus, this lawsuit does not threaten existing securitizations because if MERS, Inc. loses the private lawsuit, that means it lacks authority to assign and foreclose mortgages, which means it lacks authority to sell mortgages. However, MERS, Inc. could settle the private lawsuits for a large sum without admitting the underlying facts, courts could find that MERS, Inc. lacked authority to convey mortgages but created the impression that it did, or MERS, Inc.'s bankruptcy court could simply decide the issues differently, as it probably would not be bound by any collateral estoppel effect of rulings in the main lawsuit.

“bankruptcy remote” entity, apparently at the insistence of credit rating agencies.⁶⁵ Even if MERS, Inc. cannot enter bankruptcy voluntarily,⁶⁶ the entity could be forced into involuntary bankruptcy by creditors.⁶⁷ Indeed, the possibility that a bankruptcy trustee could reach the mortgages MERS owns increases the likelihood that creditors would pursue this course.

III. TREATMENT OF MERS MORTGAGES IN BANKRUPTCY

If MERS, Inc. enters bankruptcy, its bankruptcy trustee can bring into the bankruptcy estate any real property interests that MERS, Inc. could convey to a bona fide purchaser. The mortgages registered in MERS, Inc.’s name are real property interests, and a court could properly find that MERS, Inc. could convey them to a bona fide purchaser. Thus, the MERS, Inc. bankruptcy trustee could properly bring the mortgages into MERS, Inc.’s bankruptcy estate. It is certainly possible that a court might find that the mortgages would not enter the estate. But the risk of such a ruling, combined with the very serious consequences if a court should make such a finding, suggests the existence of a design flaw in MERS.

A. The MERS, Inc. Bankruptcy Trustee Probably Could Bring into the Bankruptcy Estate Any Mortgages That MERS, Inc. Could Convey to a Good-Faith Purchaser

When an entity enters into bankruptcy, its property becomes part of the “bankruptcy estate.”⁶⁸ In the words of the Bankruptcy Code, the estate consists of “all legal and equitable interests of the debtor as of the commencement of the case.”⁶⁹

The Bankruptcy Code also provides that the bankruptcy trustee⁷⁰ has several special powers to expand the bankruptcy estate beyond the legal and equitable interests of the debtor at

⁶⁵ See Hultman Dep., *supra* note 3, at 32.

⁶⁶ See Hultman Dep., *supra* note 3, at 33 (MERS, Inc. has an independent director who must vote in favor of bankruptcy before the company can seek bankruptcy protection).

⁶⁷ See 11 U.S.C. § 303 (commencement of involuntary bankruptcy case).

⁶⁸ 3 ALAN N. RESNICK ET AL., COLLIER BANKRUPTCY MANUAL § 541.01, at 541-3 (3d ed. 2010).

⁶⁹ 11 U.S.C. § 541(a)(1).

the commencement of the case—in other words, to add certain types of property to the bankruptcy estate and bring them within the reach of creditors.⁷¹ These powers are set forth in section 544 of the bankruptcy code and are called the trustee’s “strong-arm powers.”⁷²

It is critically important that the trustee’s strong-arm powers generally derive from bankruptcy’s origin as a class action for *creditors*.⁷³ Although the strong-arm powers exceed the rights of creditors in some respects, they are founded on the rights of creditors, *not* on the debtor’s ownership of property.⁷⁴ That a debtor does not “own” certain property has nothing to do with whether the trustee can reach the property under the strong-arm powers, which arise from a different origin and have a different purpose. This point is essential because parties resisting the trustee would argue that MERS, Inc. is not the “true,” or “beneficial” owner of the mortgages recorded in its name, but only the owner of “legal title” as a “nominee.” But MERS’ lack of beneficial ownership simply does not dispose of the question whether the mortgages would enter the bankruptcy estate under the strong-arm power.

⁷⁰ The bankruptcy trustee represents the bankrupt debtor’s creditors as a group. JOHN D. AYER & MICHAEL L. BERNSTEIN, *BANKRUPTCY IN PRACTICE* 324(3d ed. 2006). To say that the trustee has the power to bring property into the estate is to say that that the creditors as a group can reach the property, or in other words to say that the property is not bankruptcy remote.

⁷¹ *Belisle v. Plunkett*, 877 F.2d 512, 516 (7th Cir. 1989) (Easterbrook, J.) (“[W]e believe that allowing the estate to benefit from property the debtor did not own is exactly what the strong-arm powers are about . . . The estate gets what the debtor could convey under local law rather than only what the debtor owned under local law—a critical distinction . . .”) (emphasis in original).

⁷² See 11 U.S.C. § 544; 3 RESNICK, *supra* note 68, § 544.02[1], at 544-3 (trustee’s powers under Section 544 are “strong-arm powers”).

⁷³ See AYER & BERNSTEIN, *supra* note 70, §14.5 at 324.

⁷⁴ See *In re Sedona Cultural Park, Inc.*, No. AZ-06-1339-MoPaBr, 2007 WL 7540968, at *8 (9th Cir. B.A.P. 2007) (“Under the majority rule Sections 541 and 544 are complementary, not conflicting, sources of Trustee’s rights and powers”); *In re Great Plains W. Ranch Co.*, 38 B.R. 899 (Bankr. C.D. Cal. 1984) (Ayer, J.).

Although some of the trustee's strong-arm powers track creditor's rights directly,⁷⁵ the trustee's rights respecting real property interests, set forth in Section 544(a)(3) of the Code, are those of a purchaser rather than a creditor:

The trustee shall have, as of the commencement of the case, and without regard to any knowledge of the trustee or of any creditor, the rights and powers of, or may avoid any transfer of property of the debtor or any obligation incurred by the debtor that is voidable by—

...

*(3) a bona fide purchaser of real property, other than fixtures, from the debtor, against whom applicable law permits such transfer to be perfected, that obtains the status of a bona fide purchaser and has perfected such transfer at the time of commencement of the case, whether or not such a purchaser exists.*⁷⁶

Mortgages are considered interests in real property under the law of most states,⁷⁷ and “real property” under Section 544(a)(3) apparently encompasses all real-property interests, not just fee simple interests.⁷⁸

The text of Section 544(a)(3) is far from clear, and scholars who have tried to explain it are deeply divided over whether the provision permits the trustee only to avoid unrecorded transfers or instead enables the trustee to take any real property interest the debtor could have conveyed.⁷⁹ The courts too disagree on the provision's meaning, but the majority view is the

⁷⁵ See 11 U.S.C. §§ 544(a)(1)–(2) (conferring on trustee powers of “a creditor that extends credit to the debtor at the time of the commencement of the case” and obtains a judicial lien against the debtor's property or execution against the debtor returned unsatisfied).

⁷⁶ 11 U.S.C. § 544(a)(3).

⁷⁷ See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES (1997) § 1.1. The authors have reviewed the real property statutes of the ten states with the largest number of private-label securitized mortgages. Our review indicates that mortgages are considered real property interests in nine of the ten states. The detailed results of our review are on file with the authors.

⁷⁸ See *Belisle*, *supra* note 71, at 515 (applying Section 544(a)(3) to transfer of leasehold interest); *Missouri Breaks, LLC v. Burns*, 791 N.W.2d 33 (N.D. 2010) (applying § 544(a)(3) to “working interest” in oil well, where “working interest” apparently is an interest in a leasehold interest). But see *In re BFA Liquidation Trust*, 331 B.R. 907, 913 (D. Ariz. 2005) (distinguishing between “real property” and “an interest in real property” without further analysis); *In re Ascot Mortgage, Inc.*, 153 B.R. 1002 (N.D. Ga. 1993) (“doubtful that Congress intended § 544(a)(3) to come into play when the underlying real property is not in dispute”).

⁷⁹ The leading alternative to the majority view explained herein is that Section 544(a)(3) permits the trustee only to avoid unrecorded transfers of real property interests away from the debtor. For a sample of the scholarly literature on the provision, see Callen Bair, *Twisting the Trustee's “Strong Arm”: Constructive Notice in Section*

latter of these: the trustee takes whatever real property interests the debtor could *convey*, regardless of what the debtor “owns.”⁸⁰ In the context of a MERS, Inc. bankruptcy, that means that if MERS, Inc. could convey title to the mortgages recorded in its name to a bona fide purchaser, the MERS, Inc. bankruptcy trustee could bring those mortgages into the estate.

The textual basis for the majority interpretation is that “[t]he trustee shall have ... the rights and powers of ... a bona fide purchaser of real property ... from the debtor ... whether or not such a purchaser exists.”⁸¹ That is, if a bona fide purchaser had paid to buy the mortgage from MERS, Inc. and had “perfected” (recorded) the interest when MERS, Inc. entered bankruptcy, and if doing so would defeat the unrecorded claim of the “true” owner (usually a securitization trustee),⁸² then the mortgage could be brought into the bankruptcy estate.

It is critical to recognize that Section 544(a)(3) speaks of a *hypothetical* purchaser of real property.⁸³ The bankruptcy trustee’s powers over real property interests are not measured by what transactions *have* taken place; they are measured by what transactions *could* take place. Thus, it is irrelevant whether MERS, Inc. has in fact sold zero, ten, or ten million mortgages to third parties, except to the extent that MERS, Inc.’s sales or lack thereof affect whether a hypothetical purchaser could take in good faith from MERS, Inc.

544(a)(3) *Adversary Proceedings*, 27 EMORY BANKR.DEV. J. 569 (2011); Andrew Kull, *Restitution in Bankruptcy: Restitution and Constructive Trust*, 72 AM. BANKR. L.J. 265 (1998); Gregg C. Gumbert, *The Trustee as a Bona Fide Purchaser of Real Property: Making Sense of Section 544(a)(3)*, 15 BANKR. DEV. J. 121 (1998); David Gray Carlson, *The Trustee’s Strong-Arm Power Under the Bankruptcy Code*, 43 S.C. L. REV. 841, 893-912 (1992); Jim D. Pappas, *The Impact and Treatment of Section 544(a)(3) of the Bankruptcy Code*, 21 IDAHO L. REV. 537 (1985).

⁸⁰ Belisle, *supra* note 71, at 516; *In re Paul J. Paradise & Assocs., Inc.*, 249 B.R. 360 (D. Del. 2000) 4 NORTON BANKR. L. & PRAC. § 63:6 (2012) (“[A] minority of courts have held that the subsection applies only to real property transfers by the debtor to a third person. The majority of courts construe Code § 544(a)(3) broadly as giving the trustee bona fide purchaser status, even where there has been no transfer from the debtor to a third party.”).

⁸¹ 11 U.S.C. § 544(a)(3).

⁸² As discussed in Part II. A, *supra*, the final stage of a mortgage securitization is the transfer into a special purpose vehicle, usually a trust.

⁸³ 11 U.S.C. § 544(a)(3) (“whether or not such a purchaser exists”).

Because the majority view of Section 544(a)(3) focuses on the debtor's power to convey, rather than its "true" ownership of property, Section 544(a)(3) can be used to expand "legal title" to real property into "equitable ownership"⁸⁴ when the equitable owner's interest is not recorded.⁸⁵

The most frequently cited decision in this area is Judge Easterbrook's, in *Belisle v. Plunkett*.⁸⁶ Plunkett formed several partnerships to purchase a leasehold interest in real property and used his partners' money to purchase and record the interest in his own name.⁸⁷ Under local law, Plunkett's "bamboozled" partners had an equitable ownership interest in the property, and the law recognized this interest by impressing a constructive trust.⁸⁸ Nevertheless, despite the partners' superior claim of equitable ownership, the trustee was able to bring the property into the estate under Section 544(a)(3):

If a hypothetical bona fide transferee from the debtor would come ahead of the 'true' owner's rights, then the trustee takes ahead of the true owner.⁸⁹

Thus, the bankruptcy trustee and not the partners took the leasehold interest, because "[a] bona fide purchaser of the leasehold interest, without notice of the earlier claim, would take

⁸⁴ JASON H.P., KRAVITT ET AL., *SECURITIZATION OF FINANCIAL ASSETS* §5.02[G] (2d ed. 2010) at 5-42 n.162.

⁸⁵ See *In re Granada*, 92 B.R. 501, 509 (Bankr. D. Utah 1988) (bankruptcy trustee of debtor owner of bare legal title to real property prevailed over partnership that claimed unrecorded equitable ownership interest). It is sometimes said that Section 541(d) of the Bankruptcy Code cuts against the majority interpretation of Section 544(a)(3). Section 541(d) provides that "[p]roperty in which the debtor holds, as of the commencement of the case, only legal title and not an equitable interest ... becomes property of the estate *under subsection (a)(1) or (2)* of this section only to the extent of the debtor's legal title to such property, but not to the extent of any equitable interest." The italicized language seems to dispose of the argument, as the majority approach holds that property enters the estate under Section 544(a)(3), not Section 541(a)(1) or (2). Nevertheless, cases taking the minority view of the strong-arm powers often rely on Section 541(d). See, e.g., *In re Quality Holstein Leasing*, 752 F.2d 1009, 1013 (5th Cir. 1985) ("As a general rule, it must be held that section 541(d) prevails over the trustee's strong-arm powers"). *Quality Holstein Leasing* did not specifically address Section 544(a)(3), and apparently considered an older version of Section 541(d).

⁸⁶ 877 F.2d 512 (7th Cir. 1989).

⁸⁷ *Id.* at 513.

⁸⁸ *Id.* at 513.

⁸⁹ *Id.* at 515.

ahead of a person who has not recorded his entitlement.”⁹⁰ Judge Easterbrook followed the logic of state recording laws: “Under most states’ laws ... the buyer in good faith of *real* property can obtain a position superior to that of the rightful owner, if the owner neglected to record his interest in the filing system. Section 544(a)(3) gives the trustee the same sort of position.”⁹¹

The approach Judge Easterbrook followed in *Belisle v. Plunkett*, that the rights of the trustee are measured by the rights of a bona fide purchaser, that this permits legal title to defeat unrecorded equitable ownership, and that this result is justified at least in part by the interest in encouraging recording, has been called the “majority”⁹² approach and has been followed repeatedly.⁹³

When a debtor’s bankruptcy estate is expanded under Section 544(a)(3) to property that the debtor does not own prior to bankruptcy, usually there is some other claimant to the property who is harmed by the expansion—perhaps one who is quite sympathetic. When the property enters the bankruptcy estate, that person may have to share the value of the property with other creditors, which may seem unfair. For example, in many of the cases that follow the majority approach, the competing claimant was, or was assumed to be, the victim of fraud by the debtor.⁹⁴

⁹⁰ *Id.* at 514.

⁹¹ *Id.* at 515 (emphasis in original).

⁹² See *In re Seaway Express Corp.*, 912 F.2d 1125 (9th Cir. 1990).

⁹³ See *Seaway Express*, 912 F.2d at 1129 (trustee prevailed over bank claiming unrecorded equitable interest in real property exchange for account in which bank had security interest; state law “permits perfection of an interest such as [the bank’s] and “provides clear procedures for attaining that goal”); *In re Tleel*, 876 F.2d 769, 772 (9th Cir. 1989) (trustee prevailed over party assumed to be partner of debtor claiming interest in real property held in constructive trust, where partner “did not record his alleged interest”); *In re Roman Catholic Archbishop of Portland in Oregon*, 335 B.R. 868 (Bankr. D. Ore. 2005) (trustee prevailed where claimed, and assumed true for purpose of decision, that debtor held real property in express trust for benefit of others; what determines avoidability is whether “there was constructive [*i.e.*, record] notice of that interest at the time of bankruptcy”); *In re Great Plains W. Ranch Co.*, 35 B.R. 899, 905 (Bankr. C.D. Cal. 1984) (even assuming that the general partner debtor who was record owner of real property had defrauded limited partners out of purchase price and therefore held property in constructive trust for limited partners, property nevertheless entered bankruptcy estate under § 544(a)(3); “the law of real property is built around the recording acts.”); *Patel v. Rupp*, 195 B.R. 779 (D. Utah 1996); *In re Ebel*, 144 B.R. 510 (D. Colo. 1992); *In re Reasonover*, 235 B.R. 219, 227 (Bankr. E.D. Va. 1999) (“The majority view, which this court finds more persuasive, fully support[s] the position that § 541(d) does not trump the trustee’s avoidance powers.”); *In re Granada, Inc.*, 92 B.R. 501 (Bankr. D. Utah 1988).

⁹⁴ See, *e.g.*, *Belisle*, *supra* note 71; *In re Great Plains W. Ranch Co*, *supra* note 74.

When someone is defrauded out of the purchase price of real property, forcing that person to share the value of the property with other, non-defrauded creditors—such as those who simply took a calculated business risk in dealing with the debtor—may seem harsh. Indeed, the majority approach to Section 544(a)(3) has been criticized on this ground, and some courts would limit Section 544(a)(3) to the avoidance of an “actual transfer” by the debtor.⁹⁵

Despite those arguments, courts and scholars have identified two related policies the broad interpretation helps to advance, and both policies disfavor the use of MERS. The first is the policy of protecting those who act in reliance on “ostensible ownership.”⁹⁶ A fundamental problem of property law is that when the apparent owner of property is not the “true” owner, a buyer who deals with the apparent owner is likely to be prejudiced. One potential implication is that buyers who are aware of this danger will be reluctant to transact and/or will incur excessive costs trying to determine true ownership. The result could be to interfere with a dynamic commercial economy. Recording thus is to be encouraged, both to avoid prejudice to individual innocent buyers and to lubricate commerce.⁹⁷ Vindicating this policy through the Bankruptcy Code has been criticized on the ground that secret liens are a nonbankruptcy problem that ideally would be addressed by nonbankruptcy law,⁹⁸ but most commentators appear to agree that the objective purpose of section 544(a)(3) was to “address the evil of property interests with

⁹⁵ See *In re Mill Concepts Corp.*, 123 B.R. 938, 940-44 (D. Mass. 1991) (purpose of § 544(a)(3) to permit trustee to prevail over the grantee of an unrecorded mortgage and effect is limited to that purpose). The *Restatement (Third) of Restitution and Unjust Enrichment* endorses this approach. See *id.* § 60 cmt. f.

⁹⁶ See, e.g., THOMAS H. JACKSON, *THE LOGIC & LIMITS OF BANKRUPTCY LAW* 76 & n. 13 (1986); Charles W. Mooney, *A Normative Theory of Bankruptcy Law: Bankruptcy as (Is) Civil Procedure*, 61 WASH. & LEE L. REV. 931, 1029 n.502 (2004).

⁹⁷ See Doug Rendleman, *Liquidation in Bankruptcy Under the '78 Code*, 21 WM. & MARY L. REV. 575, 611 (1980) (strong-arm power under § 544(a)(3) “discourages secret liens, encourages creditors to record, and allows those who deal with the debtor to protect themselves by checking the record.”).

⁹⁸ See Thomas H. Jackson, *Avoiding Powers in Bankruptcy*, 36 STAN. L. REV. 725, 739 (1984) (“Ostensible ownership may—and often does—create problems, but it does not do so in any way that harms a collective proceeding relative to a system of individual remedies.”). Jackson does recognize that “[c]uring nonbankruptcy problems in bankruptcy may be preferable to not curing them at all.” *Id.* at 741-42.

ostensible ownership problems that remained despite available curative measures under nonbankruptcy law.”⁹⁹

The second is the special interest in encouraging real property recording. Section 544(a)(3)’s strong-arm powers for real property are, under the majority view, more expansive than the trustee’s strong-arm powers over personal property. This difference has been explained by recognizing an especially strong interest in recording real property interests. As Judge Easterbrook put it, Section 544(a)(3) exists not just to deal with the problem of “ostensible ownership,” but also, independently, to affirm the policy in favor of recording interests in real property. The partners lost because “[a] bona fide purchaser from Plunkett would have taken ahead of the partners under local law. They neglected to record the partnerships’ interest, though recording is easy.”¹⁰⁰

As explained in greater detail below, MERS has created an ostensible ownership problem by claiming—often successfully—the incidents of true ownership of the mortgages recorded in MERS, Inc.’s name. And because MERS creates unrecorded interests in real property, it undermines the special interest in real property recording. The policies underlying the majority interpretation of Section 544(a)(3) do apply to MERS.

B. There Is a Significant Risk That MERS, Inc. Can Convey the Mortgages Recorded in its Name to a Bona Fide Purchaser, Either as Owner or as Agent

MERS, Inc. holds title as a “nominee” for the mortgage lender and its successors and assigns.¹⁰¹ It could be argued that no one could reasonably think that such a “nominee,” one

⁹⁹ See Jackson, *supra* note 98, at 737.

¹⁰⁰ Belisle, *supra* note 71, at 515. Easterbrook added: “The partners could, and in retrospect should, have refused to invest funds except through an escrow agent, who would have held the cash until good title had been recorded in the partnerships’ names.” *Id.*

¹⁰¹ Mortgage, Ex. A to Affirmation of William C. Hultman, Dec. 10, 2010, filed in *In re Agard*, Case No. 10-77338-REG (Bankr. E.D.N.Y.).

designed merely to hold mortgages entered into a registration system, could sell the mortgages recorded in its name. But MERS, Inc. is presented to the world as much more than a registration system. MERS, Inc. and the members of MERS claim—often successfully—that the company can exercise all rights of the true owner of the mortgage, that MERS can convey ownership of mortgages, and that MERS owns constitutionally protected interests in mortgages and would be injured if its rights in the mortgages are impaired. As a result, a large body of precedent suggests that MERS, Inc. possesses broad authority to convey MERS mortgages either as agent or as a type of owner, and therefore that the mortgages would pass into MERS, Inc.’s bankruptcy estate if the company enters bankruptcy.

1. MERS, Inc. as Mortgage Owner

Surprising as it may seem, given that MERS is a registration system, MERS, Inc. has represented itself to mortgage borrowers as a “creditor”¹⁰² and claimed outright ownership of both the mortgages recorded in its name¹⁰³ and the associated notes.¹⁰⁴

One might dismiss such bald claims of ownership as one-off assertions of rogue counsel, corporate slips of the tongue.¹⁰⁵ That is not possible, however, for MERS, Inc.’s consistent practice of describing itself in owner-like terms and claiming owner-like rights when seeking to establish its right to participate in foreclosure proceedings. For instance, MERS, Inc. has claimed that it has a constitutionally protected property interest in the mortgages recorded in its

¹⁰² See *Trent v. MERS, Inc.*, 288 Fed. Appx. 571, 572 (11th Cir. 2008) (dismissing unfair business practice claim against MERS, Inc. based on its self-description as creditor on ground that MERS, Inc. “has the legal right to foreclose”).

¹⁰³ See *MERS v. Young*, NO. 2-08-088-DV, 2009 WL 1564994 (Tex. Ct. App. Ft. Worth June 4, 2009) (declining to accept MERS’ claim of ownership given state of record).

¹⁰⁴ See *Chase Manhattan Mtge. Corp. v. Smith*, No. C061069, 2007 WL 3225534, at *3 (Ct. App. Ohio Nov. 2, 2007) (“MERS was the mortgage holder ... MERS also owned the note on the loan.”).

¹⁰⁵ See *Zacks*, *supra* note 7, at 557-58 (arguing that claims of ownership on MERS’ behalf are typically made by inadequately supervised local counsel and that MERS’ rules officially prohibit members from making such claims).

name¹⁰⁶ and that it has standing to lift the automatic bankruptcy stay because the stay impairs MERS, Inc.’s “right to foreclose,”¹⁰⁷ causing injury in fact to MERS, Inc. MERS, Inc. has often successfully claimed to be a “real party in interest” in foreclosure proceedings, a status that typically requires—as the name suggests—a true interest in the proceedings.¹⁰⁸ MERS, Inc. has appeared as the true mortgagee in other capacities, for example litigating the issue of the priority of a MERS mortgage over a mechanic’s lien.¹⁰⁹

Even more common than claims of ownership to establish standing are claims to assign a “beneficial” interest in mortgages. Despite language in the MERS form mortgages providing that MERS, Inc. “holds only legal title” in MERS mortgages, the company’s form mortgage assignments purport to transfer “*the Assignor’s [i.e., MERS, Inc.’s] beneficial interest*” in the mortgage.¹¹⁰ Because every foreclosure on a MERS mortgage now is supposed to entail an

¹⁰⁶ *Renkemeyer v. MERS, Inc.*, No. 10-2415-JWL, 2010 WL 3878572, at *1, *2 (D. Kan. 2010) (in case where MERS, Inc. argued that its interest as holder of legal title “arises to the level of a protected property interest and that its absence would therefore violate due process” and homeowners argued that “MERS has no real interest in the mortgage as a mere nominee of the lender or the holder of the note,” finding for MERS, Inc. on ground that it “claims an interest as nominee under the mortgage that is protected by the due process clause”). *Renkemeyer* states that the “argument that MERS has no independent interest as a mere nominee of the lender would seem to contradict [the] theory that the mortgage is unenforceable because the interests of the mortgage and the note have been separated.” *Id.* at n.2. Rephrasing this statement in formal logical terms, the court seems to be saying that “no MERS interest” implies “no separation” (because it would be “contradictory” if “no MERS interest” and “separation” were both true). As any assertion of this form is identical with its contrapositive, the court seems to be saying that “separation” implies “independent MERS interest.” The court’s logic implies that the cases finding the MERS does separate mortgage and note imply that MERS does have an independent interest in the mortgage once split. *See also* *MERS, Inc. v. Bellistri*, No. 4:09-CV-731 CAS, 2010 WL 2720802, at *14 (E.D. Mo. 2010) (“MERS had a legal right to file suit to foreclose the mortgage under [state statute]. The right to file a lawsuit is a constitutionally recognized property interest.”).

¹⁰⁷ *See In re Freeman*, 446 B.R. 625, 629 (Bankr. S.D. Ga. 2010).

¹⁰⁸ *See MERS, Inc. v. Harris-Gordon*, No. L-10-1176, 2011 WL 1590082, at *1-*2 (Ct. App. Ohio April 22, 2011) (rejecting homeowner/borrower’s claim that MERS was not “real party in interest”).

¹⁰⁹ *Parkwest Homes LLC v. Barnson*, 238 P.3d 203 (Idaho 2010).

¹¹⁰ *See, e.g., Assignment of Mortgage, Ex. F to Affirmation of William C. Hultman*, Dec. 10, 2010, filed in *In re Agard*, Case No. 10-77338-REG (Bankr. E.D.N.Y.) (emphasis added). This particular assignment recites that MERS, Inc. is a nominee for First Franklin, the original lender on the mortgage. *See In re Agard*, 444 B.R. 231, 237 (Bankr. E.D.N.Y. 2011). Our review of the cases retrieved by a search on “mers /s beneficial” on Aug. 6, 2011 in the ALLCASES database retrieved 136 instances in which MERS, Inc. purported to transfer a beneficial interest in a mortgage or deed of trust and no instances in which MERS, Inc. claimed that its assignment did not transfer a beneficial interest.

assignment from MERS, Inc. to the foreclosing party,¹¹¹ one can assume that there are tens or hundreds of thousands of these assignments in existence.

Mere registration systems do not own beneficial interests in mortgages, do not have constitutionally protected property interests in mortgages, do not suffer “injury in fact” when foreclosures are delayed, and are not “real parties in interest” in foreclosure proceedings. MERS, Inc. has never presented an explanation of its apparently contradictory claims to own “only legal title” and a “beneficial interest”¹¹² in the mortgages. If MERS, Inc. is an owner, it can sell what it owns. MERS, Inc.’s claims of ownership increase the likelihood that a court would take its claims seriously and hold that a buyer could purchase mortgages from MERS, Inc. in good faith.

2. MERS, Inc. as Agent: The Power to Exercise “Any or All” Rights of the Lender

Even if a court were inclined to ignore MERS, Inc.’s many claims of actual ownership of the mortgages recorded in its name, it still would confront the bankruptcy trustee’s argument that the mortgages would enter the MERS, Inc. bankruptcy estate because of MERS, Inc.’s power to sell the mortgages as an agent for others. MERS, Inc. has claimed the right, in its capacity as an agent, to exercise “any or all” of the lender’s rights in its form mortgages, in testimony to Congress, and in countless cases litigated across the country.

The millions of mortgages recorded in MERS, Inc.’s name set forth the company’s powers in the following language:

¹¹¹ See MERSCORP, Inc. Rules of Membership, Rule 8 (July 2011).

¹¹² The distinction between “legal” and “beneficial” title to a mortgage might be challenged, but at least one state supreme court has recognized the distinction. See *Jackson v. MERS, Inc.*, 770 N.W.2d 487, 499 (Minn. 2009)(“[I]t is possible for a party to hold legal title in the security instrument—title that evidences apparent ownership but not necessarily signify a beneficial interest—without holding an interest in the promissory note”). Because MERS, Inc. claims a beneficial interest in the mortgage, the metaphysics of the legal-beneficial distinction as applied to a mortgage need not detain us further.

I [the borrower] understand and agree that MERS holds only legal title to the rights granted by me in this Security Instrument, but, if necessary to comply with law or custom, MERS (as nominee for Lender and Lender's successors and assigns) has the right:

(A) *to exercise any or all of those rights* including, but not limited to, the right to sell the Property; and

(B) to take any action required of Lender including, but not limited to, releasing and canceling this Security Instrument.¹¹³

MERS, Inc. has pressed its interpretation in Congress as well as the courts. In November 2010, MERS, Inc.'s then-President and CEO, R.K. Arnold testified that the MERS standard form mortgage "grants MERS broad rights, again as nominee for the lender and the lender's successors and assigns, 'to exercise any or all' of the interests granted by the borrower under the mortgage."¹¹⁴

The power to "exercise any or all" rights of the lender is central in the struggle between MERS and defaulting mortgage borrowers. In the typical foreclosure case involving a MERS mortgage, MERS, Inc. is seeking to foreclose in its own name or has assigned the mortgage to a securitization trustee or servicer that seeks to foreclose. If MERS, Inc. seeks to foreclose in its own name, the borrower argues that MERS, Inc. lacks standing to foreclose because it is a mere "nominee" and MERS, Inc. responds that it has standing to foreclose because it can exercise "any or all" rights of the lender and its successors and assigns.

In the more common case where MERS, Inc. has purported to assign the mortgage to a securitization trustee or servicer to foreclose,¹¹⁵ the borrower claims that MERS, Inc.'s status as

¹¹³ Mortgage, Ex. A to Affirmation of William C. Hultman, Dec. 10, 2010, filed in *In re Agard*, Case No. 10-77338-REG (Bankr. E.D.N.Y.) (emphasis added). Other form documents refer to "any or all interests" granted the lender, rather than "any or all rights"—a difference of no apparent relevance.

¹¹⁴ Testimony of R.K. Arnold before the Subcomm. on Housing and Community Opportunity, House Financial Services Committee, Nov. 18, 2010, at 9.

¹¹⁵ MERS changed its rules in July 2011 to forbid its members from initiating foreclosures or seeking relief from the bankruptcy stay on behalf of MERS, Inc. MERS POLICY BULLETIN 2011-5 (July 21, 2011), <http://www.mersinc.org/MersProducts/bulletins.aspx?mpid=1>.

a “nominee” means that the company lacks authority to assign the mortgage, and MERS, Inc. rebuts the claim by pointing to the “any or all” language in the form mortgage signed by the borrower and recorded in the county land records.¹¹⁶

Despite the best efforts of the foreclosure defense and consumer bankruptcy bars, courts conclude more often than not that MERS, Inc. has the better of the argument:¹¹⁷ The “any or all” language in MERS, Inc.’s standardized mortgages empowers MERS, Inc. to do anything the original lender could do with the mortgage.

“Any or all” rights of the lender of course includes the power to sell the mortgage, and courts have affirmed exactly this conclusion, expressly finding that MERS, Inc. can sell mortgages. For example, in *Crum v. LaSalle Bank, N.A.*, the Alabama Court of Civil Appeals expressly held that the “any or all rights” language means that “MERS was authorized to perform any act on the lender’s behalf as to the property, *including selling the note and the mortgage to a third party*”¹¹⁸ because the recorded instrument confers on MERS, Inc. “any or all

¹¹⁶ If the borrower is in bankruptcy, the dispute will be heard in the context of a motion to lift the automatic stay.

¹¹⁷ Courts in Arizona, Arkansas, California, Georgia, Illinois, Massachusetts, Minnesota, Missouri, Nevada, New York, Ohio, Oregon, Texas, Utah, Virginia, Washington, and Wyoming have relied expressly on the “any or all” language in rejecting homeowner/borrowers’ contention that MERS, Inc. as a mere nominee, did not have the right to assign or foreclose on mortgages. See *Silving v. Wells Fargo Bank, N.A.*, No. CV11-0676-PHX-DGC, 2011 WL 2669246, at *9 (D. Ariz. July 7, 2011); *Coley v. Accredited Home Lenders, Inc.*, No. 4:10CV01870 JLH, 2011 WL 1193072, at *3 (E.D. Ark. March 29, 2011); *Perry v. National Default Servicing Corp.*, No. 10-CV-03167-LHK, 2010 WL 3325623, at *4 (N.D. Cal. Aug. 20, 2010); *In re Bryant*, 452 B.R. 876 (Bankr. S.D. Ga. 2011); *MERS, Inc. v. Barnes*, 940 N.E.2d 118, 124 (App. Ct. Ill. 2010) (quoting “any or all interests” language in support of holding that MERS could foreclose in its own name); *In re Marron*, 455 B.R. 1 (Bankr. D. Mass. 2011); *Kebasso v. BAC Home Loans Servicing, LP*, No. 11-360(DSD/AJB), 2011 WL 2960219, at *4 (D. Minn. July 20, 2011); *Kulovic v. BAC Home Loans Servicing, Inc.*, No. 4:10-CV-2058 CAS, 2011 WL 1483374, at *6 (E.D. Mo. April 19, 2011); *Chandler v. MERS, Inc.*, No. 3:10-cv-00740-RCJ-VPC, 2011 WL 3419819, at *1 (D. Nev. Aug. 2, 2011); *Deutsche Bank Nat’l Trust Co. v. Pietranico*, 33 Misc. 3d 528, 928 N.Y.S.2d 818 (Sup. Ct. 2011); *Deutsche Bank Nat’l Trust Co. v. Greene*, No. E-10-00, 2011 WL 1590296, at *2 (Ohio Ct. App. April 22, 2011); *Beyer v. Bank of America*, 800 F. Supp. 2d 1157, (D. Or. 2011); *Santarose v. Aurora Bank FSB*, No. H-10-720, 2010 WL 2232819, at *5 (S.D. Tex. June 2, 2010); *Commonwealth Property Advocates v. MERS, Inc.*, 263 P.3d 397, 400 (Utah App.), *reh’g denied*, Aug. 10, 2011, *cert. denied* 263 P.3d 397 (Utah 2011); *In re Burnett*, 450 B.R. 589, 590 (Bankr. W.D. Va. 2011); *Rhodes v. HSBC Bank USA N.A.*, No. C11-5303RJB, 2011 WL 3159100, at *3 (W.D. Wash. July 26, 2011); *In re Martinez*, No. 09-21124, 2011 WL 996705, at *5 (Bankr. D. Wyo. March 16, 2011).

¹¹⁸ *Crum v. LaSalle Bank, N.A.*, 55 So. 3d 266, 270 (Ala. Civ. App. 2009). See also *Freddie Mac v. Brooks*, No. 3:11cv313-WHA, 2011 WL 3794683, at *3-*4 (M.D. Ala. Aug. 25, 2011) (same).

of the lender's interests in the mortgaged property.”¹¹⁹ The United States District Court for the Southern District of Texas recently held that MERS' standard form language “expressly gave MERS authority to *sell or transfer* its rights and interests,”¹²⁰ so that MERS could assign a mortgage and deed of trust. Nothing in MERS, Inc.'s membership rules prohibits MERS, Inc. from selling mortgages or otherwise limits the “any or all” language on which MERS, Inc. and the members of MERS rely.¹²¹

Even if MERS, Inc. does not often exercise its power to sell mortgages, it does exercise its power to convey interests in the mortgages every day by making assignments. Indeed, it must do so to function on a nationwide basis, as many states apparently require a foreclosing party to show a chain of mortgage assignments in order to foreclose.¹²² An assignment is a “transfer of rights or property,”¹²³ so when MERS, Inc. assigns the mortgage, it transfers a right or property interest in the mortgage it is assigning. Although some courts have found that MERS, Inc. lacks the authority to assign mortgages,¹²⁴ the majority view seems to be that MERS, Inc. and the members of MERS are right, and that MERS, Inc. can pass good title to the mortgages recorded

¹¹⁹ *Crum*, 55 So.3d at 270. *Crum* rejected a homeowner/borrower's argument that the recipient of an assignment from MERS “had not acquired the power to undertake foreclosure proceedings.” *Id.* at 268.

¹²⁰ *Penrod v. Bank of New York Mellon*, 2011 WL 5562802, at *3 (S.D. Tex. Nov. 15, 2011).

¹²¹ See MERSCORP, Inc. Rules of Membership, July 2011.

¹²² Our research indicates that this is true at least of Alabama, Arkansas, Connecticut, Kansas, Massachusetts, New York, Ohio, Oregon, and Texas. See Research Mem. from Ronny Clausner to John Hunt, Jan. 18, 2012 (on file with authors). See also David R. Greenberg, *Neglected Formalities in the Mortgage Assignment Process and the Resulting Effects on Residential Foreclosures*, 83 TEMP. L. REV. 253, 266-71 (2010). (observing that courts in Ohio, Massachusetts, and New York require that a foreclosing party demonstrate a valid assignment in order to foreclose). Some states go farther and require that the chain of assignments be recorded, not just demonstrated. See OHIO REV. STATS. § 86.735; MICH. COMP. LAWS § 600.3204; MINN. STAT. § 580.02. Although these requirements apply to nonjudicial foreclosure, that is the leading form of foreclosure in those states.

¹²³ BRYAN A. GARNER ET AL., BLACK'S LAW DICTIONARY 115 (7th ed. 1999).

¹²⁴ See, e.g., *In re Martinez*, 444 B.R. 192, 206 (Bankr. D. Kan. 2011) (MERS was an agent of the lender and noteholder, so the lender “had the right to enforce the Note and Mortgage through its agent, MERS, or on its own (by directing its agent to assign the mortgage to it)”; *In re Agard*, *supra* note 110, (Bankr. E.D.N.Y. 2011) (questioning MERS, Inc.'s authorization as agent to assign mortgages).

in its name.¹²⁵ Indeed, many courts have gone farther and held that MERS also possesses actual authority to assign the promissory notes associated with the mortgages.¹²⁶

The “any or all” language upon which MERS, Inc. and MERS’ members so heavily rely is, of course, the same language that a hypothetical purchaser of the mortgage would see upon reviewing the public record. The hypothetical purchaser considering a purchase from MERS, Inc. would see that MERS, Inc., although it “holds only legal title” to the mortgage, may “exercise any or all” of the lender’s rights. If the hypothetical purchaser turns to the caselaw to understand how this standard language has been understood,¹²⁷ the buyer would rapidly learn that MERS, Inc. and the members of MERS agree that MERS, Inc. can indeed do anything that the lender itself could do, and that more generally a legal titleholder apparently can make a transfer that is good against the “true” owner.¹²⁸ Under MERS’ own theory, MERS, Inc. has the same power to sell the mortgage as the original lender.¹²⁹

One example of an agent that has plenary power to deal with property of a principal is the general partner of a limited partnership. Courts have suggested that upon bankruptcy of a

¹²⁵ See *Bertrand v. SunTrust Mortgage, Inc.*, No. 09–857–JO, 2011 WL 1113421, at *4 (D. Ore. March 23, 2011) (MERS form mortgage “grants MERS the power to initiate foreclosure and to assign its beneficial interest under the deed of trust”); *Ferguson v. Avelo Mortg., LLC*, No. B223447, 2011 WL 2139143, at *5 (Cal. Ct. App. June 20, 2011) (MERS had authority to enforce mortgage, and accordingly so did a party to which it assigned the mortgage); *In re Marron*, at *5 (under Massachusetts law, MERS is deemed to hold mortgage in trust for note owner and has power to assign it); *In re Tucker*, 441 B.R. at 645–46. See also *Perry v. National Default Servicing Corp.*, No. 10–CV–03167–LHK, 2010 WL 3325623, at *4 (N.D. Cal. Aug. 20, 2010); *Baisa v. Indymac Federal Bank*, No. CIV. 09–1464 WBS JMF, 2009 WL 3756682, at *4 (E.D. Cal. Nov. 6, 2009). Although *Perry* and *Baisa* involved deeds of trust, they have been cited in cases involving “true” mortgages without any distinction being made, see *In re Marron*, 455 B.R. 1 (D. Mass. 2011); and MERS, Inc.’s form assignment does not appear to be different in states where “true” mortgages predominate.

¹²⁶ See, e.g., *Taylor v. Deutsche Bank*, 44 So. 3d 618, 622–23 (Fla. Dist. Ct. App. 2010) (finding that MERS’ assignment of mortgage assigned note with it); *Deutsche Bank v. Greene*, No. E–10–006, 2011 WL 1590296, at *3 (Ohio Ct. App. April 22, 2011).

¹²⁷ Cf. RESTATEMENT (SECOND) OF CONTRACTS § 211(2) (form contract language should be given a uniform interpretation wherever reasonable).

¹²⁸ See 8A AM. JUR. 2D BAILMENTS § 62 (2011) (“[I]f the bailor entrusts written evidence of title or a power of disposition to the bailee, ... an unauthorized transfer by the bailee normally will bind the bailor; in such a case, the bailor will be estopped from asserting title as against an innocent transferee.”).

¹²⁹ It might be argued that the “necessary to comply with law or custom” language limits MERS, Inc.’s authority to sell mortgages, but none of the courts citing the “any or all” language has construed this “necessary to comply” clause as limiting MERS, Inc.’s authority.

general partner with authority to convey real property of the partnership, the real property would enter the general partner's bankruptcy estate under Section 544(a)(3), even if the partnership's interest is accurately recorded.¹³⁰ Because MERS does not record even the current identity of the mortgage owner, it presents a stronger case for real property's passing into the bankruptcy estate. For example, many state statutes provide that when a recorded instrument discloses only that a party holds title to land as a "trustee," without identifying the beneficiary, a purchaser can cut off the beneficiary's interest and is under no duty to ascertain the terms of the trust for itself.¹³¹

The form documents, statements to Congress, and litigating positions of MERS, Inc. and the members of MERS establish that these parties claim that MERS, Inc. can sell mortgages. It appears that most courts agree, explicitly or implicitly finding that MERS, Inc.'s form mortgages and membership agreements do confer on MERS, Inc. the power to sell mortgages. In other words, they find that MERS, Inc. has actual authority to sell. But even if MERS, Inc. lacked actual authority to sell mortgages, the bankruptcy trustee still could prevail. A purchaser would not be limited to arguing that MERS, Inc. possesses actual authority to sell, so neither is the bankruptcy trustee. The bankruptcy trustee could rely on theories of apparent authority and estoppel, arguing that MERS' members have held MERS, Inc. out to the world as an entity that can do whatever the lender itself can do with a mortgage, including selling it, and should not be allowed to deny MERS' authority to sell mortgages when it is convenient for them to do so. These theories are not presented in foreclosure litigation, where the defaulting borrower seeks to deny, rather than affirm, MERS' powers. Thus, even foreclosure decisions that conclude that MERS lacks actual authority to sell mortgages should not obstruct the trustee in a MERS, Inc. bankruptcy proceeding.

¹³⁰ See *In re Granada*, 92 B.R. 501, 508 (D. Utah 1988).

¹³¹ See AMY MORRIS HESS ET AL., *THE LAW OF TRUSTS AND TRUSTEES* §45 n.26 (3d ed. 2007).

C. MERS, Inc. as Hybrid Owner-Agent Under Section 544(a)(3)

It is hard to avoid the conclusion, reached by others,¹³² that MERS is fundamentally self-contradictory. As convenient in the circumstances, MERS, Inc. purports to assume the form sometimes of a passive nominee,¹³³ sometimes of a robust agent, and sometimes of a true owner.

If a bankruptcy trustee sought to bring the MERS mortgages into MERS, Inc.’s bankruptcy estate, parties resisting the motion undoubtedly would present MERS, Inc. as nothing but the pallid, insubstantial tender of a registration system. They would argue that the company is a mere agent and that Section 544(a)(3) does not cover sales of real property by agents on behalf of others. They also would point to Bankruptcy Code Section 541(b)(1), which provides, “Property of the bankruptcy estate does not include . . . powers the debtor may exercise solely for the benefit of another.”¹³⁴

¹³² See Peterson, *Two Faces*, *supra* note 7, at 113 (“Like Janus, MERS is two-faced: impenetrably claiming to both own mortgages and act as an agent for others who also claim ownership”); Weber, *supra* note 7, at 2 (“[T]he MERS model propagates a false dichotomy where MERS as the nominee or agent of the mortgagee can claim to be the mortgagee when that status is to its benefit, while simultaneously disclaiming that role as it sees fit”); Zacks, *supra* note 7, at 552 (“MERS’s arguments to courts are so numerous and contradictory as to make pinning down one core theory of standing impossible.”); *id.* at 585-88 (describing MERS as “more akin to a many-tentacled squid” than to Janus, and documenting inconsistencies in MERS’ positions about whether it possesses promissory notes, is the beneficial owner of notes, has standing individually or as a nominee, and whether MERS, Inc. assigns notes and mortgages, whether MERS, Inc. receives consideration in exchange for assignments).

¹³³ See *MERS, Inc. v. Nebraska Dep’t of Banking*, 704 N.W.2d 784, 787 (Neb. 2005) (affirming MERS, Inc.’s position that it “is not a mortgage banker because it only holds legal title to members’ mortgages in a nominee capacity”).

¹³⁴ It does not appear that any reported case has addressed the relationship between Section 541(b)(1) and Section 544(a)(3) of the Bankruptcy Code. Nor has any case addressed whether mortgages are “powers” covered by Section 541(b)(1), which is usually applied to trust-law matters such as powers of appointment and the power to bring a representative action on behalf of trust beneficiaries. See *In re McCann*, 318 B.R. 276, 286 (Bankr. S.D.N.Y. 2004). This in itself makes reliance on the provision by MERS’ proponents foolhardy. In any event, it is unclear that Section 541(b)(1) restricts the strong-arm powers at all, rather than limiting what property enters the estate in its capacity as successor to the debtor. The 1898 Bankruptcy Act presents the strong-arm powers (Section 70a(5)) as cumulative to the “powers which [the debtor] might have exercised for its own benefit, but not those which he might have exercised for some other person,” *id.* §70a(3), and Congress apparently did not intend to change the meaning of Section 70a(3) when it reenacted and reorganized the provision in the 1978 Bankruptcy Act. See *In re Herrell*, 210 B.R. 386 (Bankr. M.D. Fla. 1997). Moreover, Section 541(b)(1) is strictly limited to powers the debtor can exercise *solely* for the benefit of another. See 5 COLLIER ON BANKRUPTCY (16th ed. 2011) ¶ 541.17, at 541-79 (“[I]f the power in question may be exercised for the benefit of another entity, but is capable of conferring benefit on the debtor also, it becomes property of the estate”). If MERS, Inc. may benefit from the exercise of mortgage powers, the provision will not apply.

Confronted with the argument that Section 544(a)(3) does not apply to MERS mortgages because MERS, Inc. is “just an agent,” the court would have to resolve the status of this novel, hybrid entity. It would have to do so with little guidance, as there is no authority bearing on how Sections 544(a)(3) and 541(b)(1) apply to an entity that purports to hold legal title to real property interests as an agent, on how the provisions apply to an hybrid owner/agent such as MERS, Inc., or on how they apply to an entity that purports to circumvent mortgage recording statutes on a national basis.

1. Policies Underlying Section 544(a)(3): Avoiding “Ostensible Ownership” Problems and Encouraging Use of the Recording System

In applying Section 544(a)(3) to MERS, Inc., a court would ask how the reasons given for the expansive strong-arm power under Section 544(a)(3) apply to the company and its operations. Section 544(a)(3) grants the trustee greater powers than those possessed by creditors, and it does so apparently in order to promote the interest in public land recording.¹³⁵ To the extent the widespread use of MERS has degraded the public land records,¹³⁶ the policy underlying Section 544(a)(3) supports applying the provision for the benefit of MERS, Inc.’s creditors.

For example, a party dealing with MERS, Inc. as an agent that is empowered to sell or encumber real property for an undisclosed principal faces uncertainty. If the identity of the principal were recorded, the prospective purchaser would be on notice of the relationship and could use the land records to determine how to confirm the agent’s authority to enter into the transaction. This usually is not the case in MERS transactions. Although using MERS does not hide the existence of mortgages, MERS obscures the identity of its principal because the system

¹³⁵ See discussion *supra* Part III. A.

¹³⁶ See Peterson, *Foreclosure*, *supra* note 7, at 1400-04 (describing “atrophy of the land title infrastructure” due to MERS).

informs the borrower only that MERS, Inc. is a nominee for the original lender “and its successors and assigns.”¹³⁷ In the usual case, the original lender will no longer have any interest in the mortgage and thus will not be the party on whose behalf MERS holds title, but it will be the only party whose identity is disclosed.

A party contemplating a purchase from MERS, Inc. as agent would be able only to determine that MERS, Inc. *is* an agent, not for whom it is an agent, permitting various types of fraud. For example, the original lender, having securitized the mortgage, could purport to sell the mortgage to a new party through MERS and direct MERS, Inc. to record an assignment. The second buyer’s only defense against this tactic is MERS, Inc.’s internal controls. These allegedly are quite deficient,¹³⁸ and in any event purchasers should not be charged with monitoring them. Recording that MERS, Inc. holds title as a common agent for the lender “and its successors” creates ostensible ownership problems and degrades the quality of public land records – exactly the problems that the broad scope of Section 544(a)(3) is meant to address.¹³⁹

2. Creditors’ Ability to Reach Property Held for Principal

The court might also look to precedents addressing when a creditors can reach property of another in the hands of a debtor. In doing so, it should bear in mind that the trustee’s rights to real property under Section 544(a)(3) exceed those of an ordinary judgment creditor. If these authorities are persuasive as applied to MERS, then the trustee could reach MERS mortgages on behalf of MERS, Inc.’s creditors, but the inverse is not true.

¹³⁷ See Mortgage, *supra* note 101, at 1.

¹³⁸ See Delaware Complaint, *supra* note 42, at ¶¶45-50 (alleging that MERS, Inc. and MERSCORP. Inc. do not select or supervise the MERS, Inc. officers who are permitted to assign mortgages on behalf of MERS, Inc.); New York Complaint, *supra* note 32, at ¶¶ 47-53 (alleging MERS, Inc.’s failure to supervise certifying officers).

¹³⁹ See also HESS ET AL., *supra* note 131 (listing states that permit bona fide purchasers to avoid trusts where trust details are not recorded).

One common situation where an agent holds property on behalf of a principal is that of a consignment sale of goods, where a consignor entrusts its goods to a consignee for sale. In the typical arrangement, the consignee holds no title to consigned goods and would breach its agency agreement with the consignor if it used the proceeds of a consignment sale to pay its own creditors rather than remitting the funds to the consignor.¹⁴⁰ Nevertheless, if the consignee enters bankruptcy, its assets pass to the bankruptcy estate rather than being returned to the consignor unless the consignment relationship is recorded.¹⁴¹ The agent's bankruptcy exposes the principal's property to creditors' claims. Although filing an appropriate statement under the U.C.C. protects the consignor from this result, whether MERS, Inc.'s filing practices satisfy state recording law is doubtful.¹⁴²

3. Estoppel to Deny MERS, Inc.'s Authority to Convey Mortgages

Even in cases where creditors ordinarily could not reach property held for another, principles of estoppel still operate. If the principal has induced a lender to treat the agent as the “true” owner of property, the principal will be estopped to deny the lender's claims to the

¹⁴⁰ See, e.g., Eric R. Roper, *Consignment Agreements*, 297 PLI/PAT 481 (1990) (explaining that consignment agreements establish a relationship in which the consignor is the principal and the consignee is the agent, and providing a sample agreement according to which consignee is to pay all proceeds of sale, net of commission, to consignor within a specified period of time).

¹⁴¹ See *In re WFG. LLC*, No. 09–11265, 2010 WL 4607614, at *2 (Bankr. E.D. Tenn. Nov. 3, 2010) (consigned property returned to consignor shortly before bankruptcy may be brought back into bankruptcy estate for distribution to creditors); Steven O. Weise, *Personal Property Secured Transactions*, 66 BUS. LAW. 1165, 1166 (2011) (consignments become part of bankruptcy estate unless consignor makes UCC filing to protect interest).

¹⁴² See discussion *supra* Part I. III. B.2. Consignment sellers may present an especially strong case for the fairness of creditors to reach property held for another, because there is an especially high risk of confusing lenders: The Uniform Commercial Code treats as consignments only situations where the consignee is a merchant that “deals in goods of the kind” and “is not generally known by creditors to be substantially engaged in selling the goods of others.” U.C.C. § 9-102(20). Because MERS, Inc. does not regularly sell mortgages – although it does regularly convey them and claim the right to sell them – there may be less chance of confusion than in the case of a consignment seller. Nevertheless, the consignment-sales example establishes that it is possible for property held by an agent to enter the agent's bankruptcy estate. If MERS, Inc. is less than a consignment seller, it is certainly much more than a bank providing a safe deposit box or a storage facility providing a locker. It would make little sense to expose the property in the care of such custodians to creditors' claims, but that is precisely because those entities, unlike MERS, Inc., have and claim no authority to sell or assign the property in their hands.

property upon the agent's insolvency.¹⁴³ MERS members that are complicit in MERS, Inc.'s claims of mortgage ownership, such as those who made such claims on MERS' behalf or acquiesced in the making of the claims,¹⁴⁴ should be estopped to deny MERS, Inc.'s true ownership of the mortgages if the company enters bankruptcy.

MERS, Inc. unusual – not to say bizarre – status as a hybrid owner-agent creates problems. It seems quite optimistic to assume that a court forced to confront this hybrid status and adjudicate its effects on MERS' creditors would resolve the relevant issues against MERS, Inc.'s creditors simply because the parties resisting the trustee decide to emphasize the agency aspect of MERS' dual nature and deemphasize the ownership aspect. Such an assumption is even more optimistic given that MERS, Inc.'s creditors in bankruptcy by hypothesis would be tort plaintiffs and public officials seeking to collect money MERS, Inc. owes because of some form of wrongdoing,¹⁴⁵ not parties that voluntarily extended credit to the company.

4. Countervailing Policy Arguments: MERS Is Efficient, and in Any Event “Too Big to Fail”

To be sure, a court might weigh the argument that MERS saves time and money that otherwise would be spent on recording mortgage assignments. Beyond MERS' putative efficiency benefits, it might be argued that MERS, Inc. is too big to fail.¹⁴⁶ Precisely *because* of

¹⁴³ See 8 CORPUS JURIS SECUNDUM § 112 (“*In the absence of statute or estoppel*, the bailor’s title to the bailed property is good as against claims of the bailee’s creditors.”); *id.* § 113 (in case of sale or transfer by bailee, “[i]f the conduct of the bailor has been such as reasonably to lead the third party to believe that the title to the property was in the bailee, the bailor is to set up his or her title against such third party.”); Note, *Bailments – Estoppel of Bailor*, 10 TEX. L. REV. 498, 498 (1932) (“It is a well settled rule that a *bona fide* purchaser for value of a chattel from one having mere possession as a bailee does not acquire title. However, the owner may by his own voluntary conduct confer upon his bailee such an apparent right to the property and indicia of ownership that the owner will be estopped to set up his title against a *bona fide* purchaser for value from the bailee.”).

¹⁴⁴ See discussion *supra* Part II. C.

¹⁴⁵ See discussion *supra* Part II. C.

¹⁴⁶ Cf. ANDREW ROSS SORKIN, TOO BIG TO FAIL (2010) (describing government’s frantic efforts to save large financial institutions, often without scrupulous attention to letter of law). For a sampling of the law-review literature reviewing the dubious legality of aspects of the executive and administrative branches’ emergency reactions to the financial crisis, see Timothy A. Canova, *Financial Market Failure as a Crisis in the Rule of Law*:

the disruption that could follow any ruling that MERS mortgages enter MERS, Inc.'s bankruptcy estate, perhaps no court would ever make such a ruling. Indeed, Kenneth Kettering has made a similar argument about securitization itself. He finds fault with the legal foundations of securitization in general – arguing that the practice inherently involves fraudulent transfers¹⁴⁷ – but concludes that these faults are irrelevant in practice because the courts would be unwilling to risk disrupting the economy by recognizing and acting on the issue he identifies.¹⁴⁸

But the risk posed by MERS is completely different from that posed by securitization generally because the system concentrates so much in one place, because it puts all the eggs in one basket. If a judge finds that a single securitization is a fraudulent transfer, that finding clouds other transactions to varying degrees but might not affect any other deal directly. MERS, by contrast, is a single system operated by a single entity that could enter a single bankruptcy presided over by a single judge. A bankruptcy judge's order granting a motion to bring MERS mortgages into the MERS, Inc. bankruptcy estate could cover most or even all of the 30 million mortgages recorded on MERS.¹⁴⁹ Even assuming that the judicial system *taken as a whole* is unwilling to risk the economic disruption that would follow from a finding that the MERS, Inc. bankruptcy trustee owns the mortgages recorded on MERS, rogue decisions can and do happen. A central problem in MERS' design is that concentrating most American mortgages in the hands of a single private entity means that it takes only one decision to create enormous economic problems.

From Market Fundamentalism to a New Keynesian Regulatory Model, 3 HARV. L. & POL. REV. 369 (2009); Steven M. Davidoff & David Zaring, *Regulation by Deal: The Government's Reponse to the Financial Crisis*, 61 ADMIN. L. REV. 463 (2009); Eric A. Posner & Adrian Vermeule, *Crisis Governance in the Administrative State: 9/11 and the Financial Meltdown of 2008*, 76 U. CHI. L. REV. 1613 (2009).

¹⁴⁷ Kettering, *supra* note 34, at 1581-85.

¹⁴⁸ Kettering, *supra* note 34, at 1562-63.

¹⁴⁹ If different states' laws compel different results under 544(a)(3), a specific ruling judicial could order the return only of mortgages located in particular states.

The risk that a single court might reach the outcome described in this Article is even larger because MERS has ambiguities built into its structure and is based on untested legal theories at the intersection of commercial, real property, and bankruptcy law. Even if a court *might* be persuaded by MERS' efficiency and *might* find that the entity is in any event too big to fail, it still seems imprudent to risk the possibility that a bankruptcy court would find that 30 million mortgages belong to MERS, Inc.'s bankruptcy trustee and not to investors.

D. Issues Relating to “Splitting the Mortgage and the Note” Do Not Interfere with the Operation of Section 544(a)(3)

It might be argued that MERS, Inc. cannot sell the mortgages to which it owns legal title, because MERS, Inc. does not have an interest in the associated promissory notes, so that selling the mortgage would “split the mortgage and the note.” This is an issue of state law, and although courts in some states have concluded that any effort to split mortgage and note is a “nullity,”¹⁵⁰ others have found that the instruments can be split.¹⁵¹ The *Restatement (Third) of Property: Mortgages*¹⁵² embraces the same view. Indeed, many decisions hold that using MERS in itself splits note from mortgage¹⁵³ – after all, using MERS does purport to vest legal ownership of the

¹⁵⁰ See, e.g., *Merritt v. Bartholick*, 36 N.Y. 44, 45 (1867) (“a transfer of the mortgage without the debt is a nullity, and no interest is acquired by it”); *Bank of New York v. Silverberg*, 86 A.D.3d 274, 926 N.Y.S.2d 532, 536 (2011) (N.Y. App. Div. 2011) (collecting New York cases following *Merritt*); *HSBC Bank USA, N.A. v. Taher*, No. 9320/09, 2011 WL 2610525 (N.Y. Sup. July 1, 2011); *In re Veal*, 450 B.R. 897, 909 (9th Cir. B.A.P. 2011); *In re Macklin*, No. 10-44610-E-7, 2011 WL 2015520 (Bankr. E.D. Cal. May 19, 2011); *In re Doble*, No. 10-11296-MM13, 2011 WL 1465559 (Bankr. S.D. Cal., April 14, 2011); *Elvin v. Wucetich*, 157 N.E. 243, 244-45 (Ill. 1927) (“It has often been decided that a mortgage cannot exist as an independent security in the hands of one person while the note it is given to secured belongs to another”); *In re Tucker*, 441 B.R. 638, 641 (Bankr. W.D. Mo. 2010) (“Effectively, the note and the deed of trust are inseparable.”).

¹⁵¹ *In re Marron*, 455 B.R. 1 (Bankr. D. Mass. 2011) (citing *U.S. Bank v. Ibanez*, 941 N.E.2d 40, 54 (Mass. 2011); *Barnes v. Boardman*, 149 Mass. 106 (1889)). *Id.* at *6 n.7 (“[T]he MERS phenomenon has created a national Massachusetts-like model where the legal and beneficial ownership of mortgages has been separated. Courts in states which do not permit the separation of ownership of notes and mortgages understandably find this a challenge which may account for some of the inconsistency in decisional authority...”).

¹⁵² RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES § 5.4 cmt. b (1996) (“A transfer of the obligation with retention of the mortgage is possible”). The Restatement contemplates a situation where the assignor retains the mortgage as an agent of the new note owner in order to facilitate collections. *Id.*

¹⁵³ See, e.g., *Jackson*, 770 N.W.2d at 494 (“MERS has essentially separated the promissory note and the security interest”); *In re Agard*, *supra* note 110; *CitiMortgage, Inc. v. Bischoff*, No. 255-4-09, Rutland Super. Ct. Vt

mortgage in a party that does not own the note. Moreover, MERS, Inc.’s own behavior (purporting to “assign” mortgages recorded in its name) and its members’ acquiescence in that behavior suggest that MERS, Inc. and the members of MERS affirm the view that mortgage and note can be separated. If mortgage and note inherently could not be separated, there would be no need for MERS, Inc. to assign the mortgage separately from the note, as MERS rules currently require.¹⁵⁴

In any event, the proposition that note and mortgage cannot be split does not really make sense. There is no compelling reasoning underlying the flat statements that note and mortgage can never be separated. Such statements seem to rest on the following argument: (1) if mortgage and note were separated, the mortgage owner could never enforce the mortgage, because only the holder or owner of the note can do that; (2) the mortgage is therefore worthless without the note; (3) the attempt to assign a valueless mortgage is a nullity.

But the second statement does not follow from the first. The right to enforce the note by selling the mortgaged property is valuable to both the borrower and the note’s owner. The mortgage has value to the borrower because if the borrower owns the mortgage, the lender cannot foreclose on the property. The mortgage has value to the lender for the same reason. Why would the lender ever sell the mortgage separately from the note? To get money. Why would anyone buy the mortgage separately from the note? The borrower might buy it as a way of

Oct. 28, 2009, at 3 MERS, Inc. v. Estrella, 390 F.3d 522, 525 (7th Cir. 2004) (“MERS is a nominee only, holding title to the mortgage but not the note”); Rinegard-Guirma v. Bank of America, N.A., No. 10-1065-PK, 2010 WL 3945476, at *4 (D. Ore. Oct. 6, 2010) (noting authority suggesting that MERS splits mortgage and deciding that it was “at least initially persuaded” that plaintiff claiming improper foreclosure based on MERS deficiencies “has a likelihood of success on the merits”); Residential Funding Co. v. Saurman (no star pagination available) (MERS held interest “in the property as security for the note, not an interest in the note itself”).

¹⁵⁴ As noted, some states require production of a chain of assignments in foreclosure. That does not appear to be a universal requirement, *see, e.g.*, Gomes v. Countrywide Home Loans, Inc., 192 Cal. App. 4th 1149 (Cal. Ct. App. 2011), and MERS rules currently require an assignment from MERS, Inc. to the foreclosing party before any foreclosure. *See* MERSCORP, Inc. Rules of Membership, Rule 8, § 1(a) (July 2011).

extinguishing the security interest, or an intermediary might buy it with the intention of selling it to the borrower, the lender, or a successor in interest to either of them.

Statements that “logic” dictates that an assignment of the mortgage without the note is a “nullity”¹⁵⁵ and that the assigned mortgage therefore is a “worthless piece of paper”¹⁵⁶ thus are erroneous. Although it is true that many courts have said that mortgage and note cannot be split, the opposing view, founded on the principle that property interests ought to be alienable, seems preferable.

Moreover, the MERS, Inc. bankruptcy trustee would not even have to split mortgage and note. If MERS, Inc. can transfer the mortgage, the note could follow the mortgage into the trustee’s hands.¹⁵⁷ The default rule articulated in the *Restatement (Third) of Property:*

Mortgages and recognized in many courts¹⁵⁸ is that the note follows the mortgage unless the

¹⁵⁵ *Merritt v. Bartholick*, 36 N.Y. 44, 45 (1867). Even some cases that state that the assignment of a mortgage apart from a note is a “nullity” appear to mean that such an assignment does effect a transfer of the mortgage, although the transferred mortgage is unenforceable until reunited with the note. *See, e.g., In re Veal*, *supra* note 150, at 916 (quoting authority that assignment of the mortgage without the note is a “nullity” in support of the proposition that “the transfer of a mortgage without the obligation it secures renders the mortgage ineffective and unenforceable in the hands of the transferee.”).

¹⁵⁶ 4 RICHARD R. POWELL ET AL., *supra* note 21, § 37.27[2] (2011), at 37-178 to 37-179 (quoting *Merritt*). *See also* *McKenna v. Wells Fargo Bank, N.A.*, No. 10-10417-JLT, 2011 WL 1100160, at *2 n.26 (“without an ownership interest in [the] promissory [n]ote, the possession of the mortgage alone is possession of a worthless piece of paper”) (D. Mass. 2011); *In re Hawkins*, No. BK-S-07-13593-LBR, 2009 WL 901766, at *4 (Bankr. D. Nev. 2009) (assignee of mortgage without note “has a worthless piece of paper”); *Manufacturers & Traders v. Figueroa*, No. CV020397258S, 2003 WL 21007266, at *2 n.6 (Conn. Super. Ct. April 22, 2003) (same).

¹⁵⁷ *See, e.g., In re Veal*, *supra* note 150, at 904-05 (distinguishing between mortgage assignment that purported to assign note and mortgage assignment that did not purport to assign note).

¹⁵⁸ *See Villa v. Silver State Fin. Servs.*, No. 2:10-cv-02024-LDG-LR, 2011 WL 1979868, at *6 n.7 (D. Nev. May 20, 2011) (noting that Restatement proposes that note follows mortgage and that Nevada Supreme Court has followed Restatement in other contexts); *Smith v. Community Lending, Inc.*, Nos. 3:10-cv-00651-RCJ-VPC, 2011 WL 1127046, at *2 (“clear” that “interest in the note may follow the deed of trust as a matter of law”); *In re Martinez*, No. 09-21124, 2011 WL 996705, at *4 n.12 (Bankr. D. Wyo. March 16, 2011) (“when the ownership of a mortgage is assigned to No. 09-21124 another, the obligation secured by the mortgage is likewise transferred” unless parties agree otherwise); *Armocost v. HSBC Bank USA*, No. 10-CV-274-EJL-LMB, 2011 WL 825151 (D. Idaho Feb. 9, 2011) (report and recommendation of magistrate judge) (assignment of mortgage with intent to assign note may effect assignment of note); *U.S. Bank, N.A. v. Flynn*, 897 N.Y.S.2d 855, 859 & n.1 (N.Y. Sup. 2010) (finding that New York’s “long standing rule that a transfer of a mortgage without a concomitant transfer of the debt is void” is “at odds with the generally prevailing common law rule that a transfer of the mortgage also transfers the debt unless the parties otherwise agree or such transfer is precluded by an applicable provision of the Uniform Commercial Code”); *Crum v. LaSalle Bank, N.A.*, 55 So. 3d 266, 270 (Ala. Civ. App. 2009). *See also* DAVID A.

parties to the transaction provide otherwise.¹⁵⁹ Thus, the power to transfer the mortgage encompasses the power to transfer the note as well, so the note is not split from the mortgage, but instead follows the mortgage into the bankruptcy estate.

MERS, Inc.'s members agree that MERS, Inc. can transfer the note along with the mortgage, and have successfully pressed this very argument before courts across the country.¹⁶⁰ They do this in foreclosures where the foreclosing party cannot produce the promissory note and seeks to cure the deficiency by producing a mortgage assignment from MERS, Inc. and claiming that the mortgage assignment carries the note with it.¹⁶¹ To be sure, many courts have heeded

SCHMUDDE, A PRACTICAL GUIDE TO MORTGAGES AND LIENS 189 (2004) ("If the parties agree, the note can be separated from the mortgage, but this requires affirmative express action"; describing such a situation as "rare").

¹⁵⁹ See RESTATEMENT (THIRD) OF PROPERTY: MORTGAGES, *supra* note 77, § 5.4(b) ("Except as otherwise required by the Uniform Commercial Code, a transfer of a mortgage also transfer the obligation the mortgage secures unless the parties to the transfer agree otherwise."). MERS, Inc. claims to be authorized to transfer both mortgage and note. The commentary explains that the phrase "except as otherwise required by the Uniform Commercial Code" refers to the fact that the right to enforce a negotiable instrument can be transferred only by delivery. *Id.* cmt. b. This does not appear to cover the transfer of beneficial ownership. Even a negotiable note could follow the mortgage in that the right to the money would be transferred, even if the right to enforce is not. See U.C.C. § 3-203, cmt. 1. See also Phillip C. Ransdell, *Note, Mortgages—Effect of Assignment without Assigning the Debt—Formalities Necessary to Transfer the Mortgagee's Title to the Mortgaged Property*, 36 N.C. L. REV. 225, 229 (1958).

¹⁶⁰ *Vega v. CTX Mortg. Co.*, 761 F. Supp. 2d 1095 (D. Nev. 2011); *In re Corley*, 447 B.R. 375 (Bankr. S.D. Ga. 2011); *Crum v. LaSalle Bank, N.A.*, 55 So. 3d 266 (Ala. Civ. App. Sept. 18, 2009); *Deutsche Bank Nat'l Trust Co. v. Greene*, No. E-10-006, 2011 WL 1590926 (Ohio Ct. App. April 22, 2011); *Deutsche Bank Nat'l Trust Co. v. Hansen*, No. 2010 CA 00001, 2011 WL 899625 (Ohio Ct. App. March 10, 2011); *Armacost v. HSBC Bank USA*, No. 10-CV-274-EJL-LMB, 2011 WL 825151 (D. Idaho Feb. 9, 2011); *Deutsche Bank Nat'l Trust Co. v. Traxler*, No. 09CA009739, 2010 WL 3294292 (Ohio App. Aug. 23, 2010); *Bank of New York v. Dobbs*, No. 2009-CA-000002, 2009 WL 2894601 (Ohio App. Sept. 8, 2009).

¹⁶¹ For this reason, the fact that MERS, Inc. might not be able to produce the promissory note to a hypothetical purchaser should not be fatal to the trustee's claim. *Cf. In re Ascot Mortgage*, 153 B.R. at 1009 (holding that because "any purported purchaser of the debtor's interest" in mortgages "would have constructive knowledge that the [d]ebtor could not produce and transfer the original notes," the trustee could not take the mortgages under § 544(a)(3)). As the common tactic of relying on a MERS mortgage assignment rather than possession of the promissory note shows, the good faith and commercial reasonableness in the mortgage industry, has not required production of the promissory notes in connection with mortgage transfers. See U.C.C. § 1-201(20) (defining good faith as "the observance of reasonable commercial standards of fair dealing"). For further evidence that the mortgage industry has operated without requiring production of notes, see Dale A. Whitman, *How Negotiability Has Fouled up the Secondary Mortgage Market, and What to Do About It*, 37 PEPP. L. REV. 737, 758 (2010) ("While delivery of the note might seem to be a simple matter of compliance, experience during the past several years has shown that, probably in countless thousands of cases, promissory notes were never delivered to market investors or securitizers, and, in many cases, cannot presently be located at all."); Garrett Wotkins, *A New Front in the Foreclosure Epidemic: Consumers Fight Back*, 1789 PLI/CORP. 477, 479 (2010) (asserting (without attribution) that "[s]ome estimate" that over 99 percent of residential foreclosure actions are filed with lost note affidavits); Bob Ivry, *Banks Lose to Deadbeat Homeowners as Loans Sold in Bonds Vanish*, BLOOMBERG.COM (Feb.

borrowers' objections to this tactic and found that MERS, Inc. cannot transfer promissory notes in this context.¹⁶² But the policy case for finding that MERS can transfer the note along with the mortgage is stronger in the context of a MERS, Inc. bankruptcy, where the mortgage owners would be pitted not against defaulting borrowers, but against law enforcement officials and involuntary creditors of MERS, Inc. who have proved in a lawsuit that MERS, Inc. wronged them.

IV. BANKRUPTCY OF MERS VERSUS BANKRUPTCY OF THE TRUSTEE OF AN EXPRESS TRUST

It might be argued that MERS mortgages would not pass into the bankruptcy estate because MERS, Inc. either is or is like the trustee of an express trust, and property interests held in trust do not enter the trustee's bankruptcy estate. After all, the trustee of an express trust exercises owner-like powers and often possesses actual and/or apparent authority to sell trust property. Yet it is treated as axiomatic by trust scholars and practitioners that property of an

22, 2008) (quoting Florida legal aid attorney as saying that 80 percent of 300 cases she had handled in past year involved lost-note affidavits). Some courts have endorsed the practice of foreclosing with lost-note affidavits. *See* *Gibson v. Wells Fargo Bank*, No. 1:10-cv-304, 2011 WL 221188, at *3 (E.D. Va. Jan. 19, 2011); *U.S. Bank, N.A. v. Fraum*, No. LLICV075002610S, 2008 WL 4033640 (Aug. 6, 2008), at *1. Indeed, the founding document of MERS embraces the goal of "immobilizing loan files," thus "eliminat[ing]" "the cost of relocating and recertifying documents." *See* INTERAGENCY TECHNOLOGY TASK FORCE, *supra* note 17, at III-6.

¹⁶² When the assignee does not hold the note, there is ample authority that an assignment of the mortgage to the assignee by MERS does not effectively transfer the note, even if the mortgage assignment purports to transfer the note as well. In other words, the note does not follow the mortgage. *See* *Bellistri v. Ocwen Loan Servicing, Inc.*, 284 S.W.3d 619, 621 (Mo. Ct. App. 2009) (MERS' attempt to transfer mortgage and "any and all notes secured by the mortgage" ineffective because MERS was not the noteholder and there was no evidence that the noteholder authorized MERS to transfer the note); *In re Weisband*, 427 B.R. 13, 19-20 (Bankr. D. Ariz. 2010) (MERS' mortgage assignment did not give assignee standing to appear in borrower's bankruptcy proceeding because note was not properly endorsed to assignee and MERS lacked an interest sufficient to confer standing); *HSBC Bank v. Miller*, 889 N.Y.S.2d 430, 432 (MERS assignment of mortgage ineffective where purported assignee could not prove it held the note; "the assertion that the note follows the mortgage is unsupported by any law"); *Rinegard-Guirma v. Bank of America, N.A.*, No. 10-1065-PK, 2010 WL 3945476 (D. Or. Oct. 6, 2010), at *4 (noting that "other courts have held that MERS does not have authority to transfer the note" and finding that homeowner was likely to succeed in challenge to securitization trustee's authority to foreclose); *In re Wilhelm*, Case No. 08-20577 (Bankr. D. Idaho July 7, 2009), slip op. at 23-24 (purported assignments by MERS ineffective where deeds did not authorize MERS to transfer promissory notes); *Saxon Mortg. Servs. v. Hillery*, No. C-08-4357 EMC, 2010 WL 5170180, at *5 (N.D. Cal. Dec. 9, 2008) (purported assignment by MERS invalid; although court assumed MERS has authority to transfer security instrument, no evidence that MERS held or had authority to assign note). *See also* *In re Veal*, *supra* note 150, at 915-16 (finding in non-MERS case that general common-law rule is that "the transfer of a mortgage without the transfer of the obligations it secures renders the mortgage ineffective and unenforceable in the hands of the transferee," although "some states may have altered this rule by statute").

express trust – real or otherwise – will not enter the estate if the trustee becomes bankrupt.¹⁶³

“Trust property does not enter the trustee’s bankruptcy estate,” the argument goes, “and MERS, Inc. is like a trustee, so MERS mortgages would not enter the bankruptcy estate.”

In evaluating this objection, one starts with the proposition that an actual purchaser in good faith from the trustee does in fact prevail over the trust beneficiary and cut off the beneficiary’s equitable interest.¹⁶⁴ Thus, if Section 544(a)(3) means that the bankruptcy trustee is in the same position as a good-faith purchaser of real property, as most courts have held,¹⁶⁵ then the bankruptcy trustee would prevail even over the beneficiary of an express trust.¹⁶⁶ Indeed, Andrew Kull argues that the majority interpretation of Section 544(a)(3) is wrong precisely *because* it causes real property held in trust to enter the bankruptcy estate.¹⁶⁷ Whatever the merits of this argument about the proper scope of Section 544(a)(3), as a matter of positive law the majority rule remains just that: the majority rule.

Indeed, a number of courts have said that the differences among constructive, resulting, express, and charitable trusts are irrelevant to the application of Section 544(a)(3).¹⁶⁸ Because

¹⁶³ See, e.g., RESTATEMENT (THIRD) OF TRUSTS § 42 cmt.c (“[T]he trustee’s personal creditors or trustee in bankruptcy may not reach either the trust property or the trustee’s nonbeneficial interest therein.”). The *Restatement* does not specifically discuss the application of Section 544(a)(3) to real property held in trust.

¹⁶⁴ See, e.g., GEORGE GLEASON BOGERT & GEORGE TAYLOR BOGERT, THE LAW OF TRUSTS AND TRUSTEES (2d ed. 1995) § 881. Whether the MERS, Inc. bankruptcy trustee would take in good faith is addressed in Part III. B, *supra*.

¹⁶⁵ See discussion *supra* Part III. A.

¹⁶⁶ See, e.g., RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 60 cmt. f (“the hypothetical status of bona fide purchaser allows the trustee to claim unencumbered title to real property held by the debtor in express trust”).

¹⁶⁷ See Kull, *supra* note 79, at 295 (majority interpretation of § 544(a)(3) would permit trustee to “distribute to creditors real property that is subject to an express trust,” so “[i]t is far, far, easier to believe no such change was intended” by addition of Section 544(a)(3)); see also RESTATEMENT (THIRD) OF RESTITUTION AND UNJUST ENRICHMENT § 60 cmt. f (2011) (characterizing majority view of Section 544(a)(3) as a “radical” interpretation under which it is “impossible to explain why § 544(a)(3) ... would not permit the bankruptcy trustee to take property subject to an express trust in the hands of a debtor/trustee, free of the interest of a beneficiary”). Kull is Reporter for the *Restatement* and presumably the author of these comments. See also *In re Mill Concepts Corp.*, 123 B.R. 938, 947 (rejecting majority interpretation of Sec. 544(a)(3) in part to “bring about the same results ... [for] trusts of all varieties”).

¹⁶⁸ See *In re Sedona Cultural Park*, No. AZ–06–1339–MoPaBr, 2007 WL 7540968, at *3 n.6 (9th Cir. B.A.P. 2007); *In re Roman Catholic Archbishop*, *supra* note 93, at 878 (Bankr. D. Ore. 2005).

the bankruptcy trustee defeats a constructive-trust claimant in the garden-variety case in which a court follows the majority view of Section 544(a)(3),¹⁶⁹ courts that say that the particular form of trust makes no difference are suggesting indirectly that real property interests held in express trusts are vulnerable.

Turning to cases that expressly consider what happens when the trustee of an express trust enters bankruptcy and that entity's bankruptcy trustee seeks to use Section 544(a)(3) to reach the trust's recorded interest in real property, little can be said for sure because the issue apparently has come up only rarely.¹⁷⁰ It does seem that courts generally are unwilling to push the majority interpretation of Section 544(a)(3) to its logical conclusion and find that the bankruptcy trustee takes real property held in a recorded express trust,¹⁷¹ although real property held in an unrecorded trust does appear vulnerable to the bankruptcy trustee.¹⁷²

In *re Cutter*, a recent case from the Ninth Circuit Bankruptcy Appellate Panel, is instructive. In this case involving a self-settled spendthrift trust, the panel held that creditors could reach real property that the debtor had transferred to an express trust in a recorded transfer because the debtor retained the power to deplete the trust and use all its assets for his own benefit.¹⁷³ In a footnote at the end of the opinion, the panel rejected the bankruptcy trustee's alternative theory that he could have reached the assets under Section 544(a)(3) even if the trust had been legitimate. The panel's concern was that "[i]f Trustee were correct, anytime a trustee of

¹⁶⁹ See discussion *supra* Part III. A.

¹⁷⁰ See *In re Cutter*, 398 B.R. 6 (9th Cir. B.A.P. 2008); *In re Roman Catholic Archbishop of Portland in Oregon*, 335 B.R. 868 (Bankr. D. Ore. 2005); *In re Mortgage Lenders Network, USA, Inc.*, 380 B.R. 131 (Bankr. D. Del. 2007); *In re Granada, Inc.*, 92 B.R. 501 (Bankr. D. Utah 1988); *In re Columbia Pacific Mortgage, Inc.*, 20 B.R. 259 (Bankr. W.D. Wash. 1981).

¹⁷¹ See *Cutter*, 398 B.R. at 6.

¹⁷² See *Columbia Pacific*, *supra* note 170, at 263 (apparently assuming *arguendo* that real property held in unrecorded express trust would enter estate, but finding that participation interests in mortgages are not real property); *Granada*, *supra* note 170, at 507 (real property claimed to be held in unrecorded express trust passed into bankruptcy estate under § 544(a)(3)); *Roman Catholic Archbishop*, *supra* note 93, at 877-78 (same). But see *Mortgage Lenders Network*, *supra* note 170, at 139 (rejecting majority view of § 544(a)(3) and holding that mortgages held in unrecorded express trust did not pass into bankruptcy estate).

¹⁷³ *Cutter*, 398 B.R. at 22.

any trust (such as a charitable trust) filed bankruptcy, his or her estate could obtain title to the corpus or assets of the trust under Section 544(a)(3), simply because third party purchasers could have obtained valid title to those assets from the debtor (as trustee of the trust) prepetition.”¹⁷⁴

As *Cutter* suggests, the reluctance to apply Section 544(a)(3) to real property held in trust seems to arise not from any flaw in the argument that the majority view of Section 544(a)(3) makes the section applicable to real property held in express trust, but because of solicitude toward express trusts themselves. If decisions refusing to apply Section 544(a)(3) to express trusts are based on protecting the institution of trust rather than on analysis of the Bankruptcy Code, then the relevant question is whether MERS would benefit from the same solicitude.

With that in mind, we turn to the proposition that MERS, Inc. would be treated like a trustee. We start with the possibility that it would be claimed that MERS, Inc. *is* the trustee of an express trust. Although no one would be surprised at any effort to cast MERS, Inc.’s protean form into yet another incarnation, it bears mention that MERS, Inc. has gone 15 years without being called an express trust. MERS, Inc.’s rules and form documents do not call MERS, Inc. a trustee and that MERS, Inc. apparently has not been called a trustee in litigation. MERS, Inc.’s website states that MERS, Inc. does not “replace the role of the trustee in Deed of Trust states.”¹⁷⁵

Any attempt to recharacterize MERS, Inc. as a trustee would face formidable obstacles. The settlor’s intent to create a trust must be “definite and particular.”¹⁷⁶ The settlor would be the party granting the property interest – the mortgage borrower who grants the mortgage to MERS,

¹⁷⁴ *Cutter*, 398 B.R. at 22 n.20. The panel also implicitly rejected the majority view of Section 544(a)(3). *Id.* ((trustee’s theory would “circumvent[] ... section 541(d)’s provision that property of the estate only to the extent of such legal title ‘but not to the extent of any equitable interest in such property that the debtor does not hold”). The majority view of Section 544(a)(3) is precisely that the provision can be used to expand legal title into equitable ownership because it measures the trustee’s powers by what can be conveyed, not by what is owned.

¹⁷⁵ http://www.mersinc.org/why_mers/faq.aspx. MERS, Inc.’s role in a deed of trust is that of beneficiary, not trustee.

¹⁷⁶ See AMY MORRIS HESS ET AL., THE LAW OF TRUSTS AND TRUSTEES § 46 (3d ed. 2007).

Inc. in return for the loan funds,¹⁷⁷ and it seems difficult to discern the borrower's "definite and particular" intent to create a trust for the benefit of MERS' members from the MERS form mortgage. Nor is it clear that the class of "Lender and its successors and assigns,"¹⁷⁸ who would be the trust beneficiaries, is "certain as to membership," as trust law requires.¹⁷⁹ Continuous supervision of an agent by a principal is said to be inconsistent with finding that the agent is a trustee,¹⁸⁰ and MERS, Inc. is in the curious position of an agent that acts *only* through its principals.¹⁸¹ Most fundamentally, the creation *vel non* of a trust is a question of state law.¹⁸² It seems imprudent simply to have assumed – or simply to assume going forward – that this novel entity would be treated as a trust when convenient and not otherwise.

Assuming that MERS, Inc. is not a trustee and given that MERS is a novel structure that has not created the kind of settled expectations that express trusts have created, one might expect a court to turn to the underlying policy considerations raised by MERS and by express trusts as a group in deciding whether to treat MERS, Inc. as a trustee. One inclined to criticize MERS might point out that its purpose was and effect has been to eliminate the existence of recorded chains of mortgage assignments across the United States. At the same time, MERS solved or appeared to solve a very real business problem afflicting most of the mortgage finance industry. Express trusts as a group have neither of these characteristics. Whether a court finds the express-trust analogy persuasive might well turn on its assessment of the conflicting policies relating to MERS.

¹⁷⁷ See Mortgage, *supra* note 113.

¹⁷⁸ *Id.*

¹⁷⁹ See BOGERT & BOGERT, *supra* note 164, at §162.

¹⁸⁰ See HESS ET AL., *supra* note 176, at § 15 n.1 (3d ed. 2007) ("An agent is subject to control of the principal, whereas a trustee is not subject to the control of the beneficiary") (citing RESTATEMENT (SECOND) OF AGENCY §§ 14B, cmts. e to h (1958)).

¹⁸¹ Given that MERS, Inc. has no employees of its own and apparently acts only through officers who are employees of its principals, its control by its principal is unparalleled. See Hultman Dep., *supra* note 3, at 69.

¹⁸² HESS ET AL., *supra* note 176, at § 45.

V. BEYOND MERS

To some extent, MERS, Inc.'s predicament is a symptom of a recording entity that just got too greedy. MERS, Inc. does not inherently need to claim the power to foreclose on mortgages in its own name or various other rights and powers as principal and agent that MERS, Inc. or the members of MERS have from time to time found it convenient to assert. A modest agent-based recording utility that sticks to recording might avoid much of the risk that the mortgages it records would enter its bankruptcy estate.

But an agent-based national recording utility that is not going to foreclose in its own name must at least claim the authority to assign (convey) legal title to mortgages, because many states require a chain of assignments as a prerequisite for foreclosure.¹⁸³ There is no avoiding the risk that a court might find that this power to convey could reasonably be interpreted by a third party acting in good faith as the power to sell. Even if the probability of such a finding is low, recording a very large number of mortgages with the same utility—so that a single court's finding could affect, say, 30 million mortgages—seems to introduce tremendous risk into the system. This appears to be a fundamental design issue with the single-agent-based national recording model, at least under current law.

Suggestions to improve MERS, though valuable, thus are problematic. For example, one commenter has suggested simply opening up MERS to public scrutiny so that members of the public could determine who owns mortgages recorded on MERS.¹⁸⁴ Although this would deal with the single most telling substantive objection to MERS — that it shrouds mortgage ownership in secrecy and enables fraud — simply making MERS more transparent would not cause it to come into compliance with state recording statutes. State laws require that mortgage

¹⁸³ See sources cited *supra* note 122.

¹⁸⁴ See Robert E. Dordan, *Mortgage Electronic Registration Systems (MERS), Its Recent Legal Battles, and the Chance for a Peaceful Existence*, 12 LOY. J. PUB. INT. L. 177, 207 (2010).

assignments be recorded with public officers, not on a private database.¹⁸⁵ Accordingly, this approach would not solve the outstanding legal problems with MERS, although it might motivate courts to look more favorably upon the system.

Another idea is to establish a federal title recording system that would accept electronic filings.¹⁸⁶ A recent Federal Reserve white paper has embraced this concept and suggested it to Congress.¹⁸⁷ To make this work, it seems that Congress would have to preempt state recording law or states would have to amend their recording statutes to give effect to records in the new federal system. Congressional preemption seems unworkable given states' historic control over land title law. Perhaps state recording statutes could be amended through the uniform-law process to accept recording of assignments on a transparent (and possibly regulated) version of MERS or on a new federal title system.

The simplest alternative to MERS—and the only alternative that seems feasible in the short term—is simply to record mortgage assignments as provided by existing state recording statutes, cumbersome and expensive though this may be. In the medium term, the present users of MERS might consider working with state and local officials to upgrade land title systems to accommodate electronic recording, as this approach could avoid the political conflict associated with either preemption or trying to persuade the states to adopt a uniform act.

Another way of addressing the concerns raised in this Article is to amend the Bankruptcy Code. Section 544(a)(3) as currently drafted is unclear and troublesome, and Congress could decide that the interest in recording that Section 544(a)(3) apparently embodies simply is less important than the interest in promoting an efficient national recording system. However, the

¹⁸⁵ See authors' survey of state recording laws, *supra* note 20.

¹⁸⁶ See Tanya Marsh, *Foreclosures and the Failure of the American Land Title Recording System*, 111 COLUM. L. REV. SIDEBAR 19, 24-26 (2011).

¹⁸⁷ BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, THE U.S. HOUSING MARKET: CURRENT CONDITIONS AND POLICY CONSIDERATIONS 24-25 (Jan. 4, 2012).

Bankruptcy Code touches many constituencies beyond mortgage industry, and efforts to amend it are often quite controversial.¹⁸⁸ Any amendment to promote national recording systems would have to be narrowly and carefully drafted to succeed.

Another possibility is to house a national recording system in an entity that is not subject to the Bankruptcy Code, such as an agency of the federal government. If policymakers decide to pursue a national system, as the Fed staff's recent proposal seems to contemplate, and decide to do so without amending the Bankruptcy Code, they should consider housing the system in an entity that is not subject to bankruptcy.

VI. CONCLUSION

MERS must have seemed like a promising way for the mortgage securitization industry to avoid dealing with thousands of county recorders to perform each of the several assignments of each mortgage in each transaction. But the system, which may not have been built on a sound legal foundation, is struggling in the financial crisis. Although MERS, Inc. and the members of MERS may be winning the ground war against defaulting borrowers, the system faces an increasing risk of insolvency due to private and public lawsuits and enforcement actions. Unfortunately for MERS' members, the MERS companies' efforts to win the foreclosure wars have increased the risk that MERS mortgages would enter the MERS, Inc. bankruptcy estate. Even without this added risk, the basic character of MERS as an agent-based national workaround of state real property recording laws present a bankruptcy risk that may be unacceptable. Policymakers should take the risk inherent in such a system into account when thinking about how to move forward in modernizing the U.S. property recording system. If

¹⁸⁸ See, e.g., Jonathan C. Lipson, *Debt and Democracy: Towards a Constitutional Theory of Bankruptcy*, 83 NOTRE DAME L. REV. 605, 688-89 (describing intense controversy surrounding enactment of Bankruptcy Abuse Prevention and Consumer Protection Act of 2005).

policymakers pursue a national substitute for MERS under current law, they should consider housing it an entity that is not subject to the Bankruptcy Code, such as a government department.